

***The current perception and practice of “Shariah Auditing”  
in Bangladeshi Islamic Banks***

**By**

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**(Md. Jahidur Rahman)**

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## Certification Page

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I, hereby declare that this research titled “*The current perception and practice of “Shariah Auditing” in Bangladeshi Islamic Banks*” has been a sincere and dedicated effort of myself under the guidance and supervision of Professor **Yasushi SUZUKI**. The sources from where I got different information have been given due credit in this thesis by following standard referencing method.

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**(Md. Jahidur Rahman)**

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## Abstract

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**Title:** *The current perception and practice of “Shariah Auditing” in  
Bangladeshi Islamic Banks*

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**Background and Problem:** Almost all the commercial banks in Bangladesh are operating Islamic banking windows throughout the country to attract Muslims (90% of the population). To ensure shariah compliance, Islamic banks in Bangladesh currently use “Internal Shariah Review” which is basically the SSC’s supervision, monitoring and controlling ‘during’ and ‘after’ the banks’ operation. However, It does not cover a thorough and comprehensive audit to examine the transactions after executing the contracts. There lies a huge functional gap between shariah compliance and internal shariah review, which is obstructing Muslims from trusting these banks.

**Purpose:** The purpose of this research was to investigate the interpretations of “Shari’ah Auditing” in Islamic Banks by accounting academicians, audit practitioners and Shari’ah scholars in Bangladesh. This research tries to measure the respondents’ idea about establishing “Shari’ah Audit” as a discipline. It also investigates whether there should be a proper shariah audit side-by-side internal shariah review and how far Shariah audit would be worth implementing.

**Methodology** Both primary and secondary data were used in this research. For collecting primary data a survey questionnaire, with both ‘open-ended’ and ‘close-ended’ questions, was designed and distributed among the accounting academicians,

audit practitioners and Shari'ah scholars in Bangladesh. A combination of quantitative and qualitative method was used to get the result. Frequency distribution method was used to examine the pattern of the respondents (Positivistic approach) and Hermeneutic approach was used to interpret the views of the respondents.

**Results and findings:** The respondents had varying experience of awareness about shariah auditing. However, most of the respondents opined that shariah auditing should be a separate discipline. While shariah scholars claimed that the internal auditor under the guidance of shariah supervisory committee should conduct shariah audit, other respondents opined that an independent professional body should conduct shariah audit. While the shariah scholars considered checking every single transaction should be the best way to ensure shariah compliance, others advocated for existing sampling method. While shariah scholars are quite satisfied, accounting academicians and audit practitioners are quite unhappy about the roles of Islamic banks in promoting shariah audit among the common people. However, most of the respondents opined that there should be a proper shariah audit side-by-side shariah review in the Islamic banks in Bangladesh. Almost all the respondents think that because of the involvement of huge transaction and monitoring costs, Islamic banks in Bangladesh are unwilling to carry out shariah audit instead of or along with shariah review.

**Recommendations:** A unique set of standards for auditing Islamic banks maintaining Islamic shariah principles has to be developed. The existing Islamic banks should maintain a shariah compliance rating for their products and service.

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## Chapter-1: Introduction

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*In this chapter the things that have been discussed are background of the study, problem statement and research objective. This chapter also includes research questions, hypotheses and justification of hypotheses.*

*An overview of the methodology, the need of the shariah auditing research and limitation of the study followed. In the end of this chapter an overview of the whole chapter is given.*

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### 1.1 Background of the study

Islamic banking system has become so popular in Bangladesh that almost all the commercial banks in Bangladesh are operating Islamic banking windows throughout the country to attract Muslims (90% of the population). However, Islamic banking did not start here with the independence. She inherited interest based conventional banking. However, within a few years Islamic banking started its journey in Bangladesh. In Bangladesh, the Islamic banking businesses started their journey in early 1980s (Khan, 2008). Statistical data shows that in 1983, Islamic banking in Bangladesh started with just one bank with three branches (**see Table 1-1**). The next Islamic bank started operating in 1987. In 1998, a traditional commercial bank opened three Islamic banking windows through just one branch. However, within 23 years the number of Islamic banks reached to 8 banks and the number of Islamic branches of traditional banks increased to 21, which shows a very sound development of Islamic banking in Bangladesh.

**Table 1-1: Bangladeshi Islamic Bank Branch Extension**

<b>Year</b>	<b>No. Of Islamic bank</b>	<b>Number of Islamic banks branch</b>	<b>Number of commercial banks Islamic window</b>
1983	1	3	
1986		18	
1987	2	24	
1995	4	123	
1996		137	
1997		152	
1998		172	1
1999		185	
2000	5	194	
2001	6	208	
2004	7	358	10
2009	8		21

Source: ([www.kantakji.com](http://www.kantakji.com))

In Bangladesh, there is a high demand for interest-free banking service. The people who are transacting with Islamic banks have a keen desire to abide by the guideline set by Islamic shariah (Mamun). However, one of the most important challenges faced by Islamic banks in Bangladesh is full compliance of shariah rules, regulations and principles in all their activities to make it more transparent and disciplined. So, in order to ensure shariah compliance, Islamic banks in Bangladesh currently use “Internal Shariah Review” which is basically the SSC’s supervision, monitoring and controlling ‘during’ and ‘after’ the banks’ operation.



## 1.2 Problem Statement

In order to understand the problem statement of the thesis, it is essential to get a well-defined illustration about current practices of shariah compliance by Islamic banks in Bangladesh. Shariah compliance can be categorized into two types. The first one is ex-ante compliance and the second one is ex-post compliance. (A.R.A, 2008) The ex-ante shariah compliance in Bangladeshi Islamic banks is basically the SSC's supervision, monitoring and controlling during the banks operation and after operation. This is done to ensure shariah compliance in the banks dealings and business. On the other hand, ex-post compliance is considers as an in-depth audit to scrutiny the transactions after the contracts is being executed by the Islamic banks. However, ex-post shariah compliance is very rare in Bangladesh.

In Bangladesh Islamic banking sector is expected to grow more rapidly in near future. Investment accounts holders with these Islamic banks needs to ensure that Islamic banks are operating by following Islamic rules, regulations, principles and fatwas properly. In order to ensure ex-ante shariah compliance, Islamic banks in Bangladesh currently using "Shariah Review" approach which is carried out Islamic banks in house Shariah Supervisory Committee (SSC). However, a thorough scrutinizing of legal contracts, documentations and operations are not properly examined by the SSC. So, there lies a huge functional gap between shariah compliance and shariah review.

In another point of view, the scope of shariah review is very limited. It includes only ex-ante compliance. That means, shariah review only check all the before task transactions including contracts, transactions and dealings. However, It does not cover a thorough and comprehensive audit to examine the transactions after performing the contracts. There lies a huge functional gap between shariah compliance and internal shariah review, which is obstructing Muslims from trusting these banks. For

examples, (1) Shariah review does not check whether the allocation of profit or loss are calculating by following Islamic shariah or not (2) Shariah review does not check whether all earnings are calculated by following prohibited activities by holly quran and sunnah or not. (3) Shariah review does not check whether all prohibited earnings goes to charitable fund or not and finally, (4) Shariah review does not check whether zakat calculation and payment are following Islamic shariah or not.

In Bangladeshi Islamic banks there is an internal audit / shariah review carried out by SSC. According to Companies Act-1994, all Islamic Banks in Bangladesh should be audited by conventional accounting professional audit firm. The conventional auditors audit these Islamic banks following the conventional accounting and auditing rules, regulations, principles, standards and framework. The conventional (external) auditor does not ensure that the Islamic banks carry out their operation maintaining the shariah compliance. This is because, conventional accounting concepts, principles and assumptions including historical cost price principle, matching principle, revenue recognition principle, the concept of objectivity, monetary unit, and the going concern assumption are contradicted with Islamic Accounting model. For example, historical cost price principle and conservatism is confusing and cannot assure the fairness and morality of the transaction that is not accepted according to Islamic shariah. According to historical cost price principle transactions are recorded on the basis of acquisition price that reflects the understated value in the financial statements and not acceptable in Islamic finance. The matching principle is immaterial because, Islamic accounting supports the accountability through Zakat. According to the conventional accounting principles, going concern means, an organization will carry on its operations for an unlimited period of time, also contradicts with Islamic accounting as this means there is something other than almighty Allah will live for an indefinite

period of time.

It is impossible for an external auditor without having solid knowledge on Islamic rules, regulations and principles to conduct audit in Islamic financial institutions. So, it is needed for an external shariah auditor to conduct shariah auditing in Islamic financial institutions according to Islamic rules, principles, fatwa and shariah.

### **1.3 Research Objective**

The objective of this research was to investigate the interpretations of “Shari’ah Auditing” in Islamic Banks by accounting academicians, audit practitioners and Shari’ah scholars in Bangladesh, issues relating to it and future implications.

### **1.4 Research Questions**

1. ***What is “Shari’ah Audit” in Islamic Banks in Bangladesh? Should “Shari’ah Audit” be an important area to become a discipline?*** This question tries to measure the understanding of the term “Shari’ah Audit” in Islamic Banks in Bangladesh by respondents and the respondents’ idea about establishing “Shari’ah Audit” as a discipline.

***Hypotheses-1:*** *It was hypothesized that the respondents would be less aware about the difference between shariah audit and conventional audit. It was also hypothesized that the respondents would feel that shariah auditing would be a separate discipline.*

2. ***Who should be the “Shari’ah Auditors” in Islamic Banks in Bangladesh and who should appoint them?*** This question tries to identify the required qualifications of the

“Shari’ah Auditors” for Islamic banks in Bangladesh and the appointers of the “Shari’ah Auditors”.

***Hypotheses-2:*** *It was hypothesized that the respondents would feel that the shariah auditor would have the qualification of both accounting and Islamic shariah. It was also hypothesized that there would be an independent body who would appoint shariah auditors in the Islamic banks in Bangladesh.*

3. ***Which areas of Islamic Banks in Bangladesh “Shari’ah Audit” should cover?*** This question covers the business areas of Islamic Banks that should be audited by “Shari’ah Audit”.

***Hypotheses-3:*** *It was also hypothesized that the respondents would feel that the scope of shariah audit would be broader than shariah review.*

4. ***When and how should “Shari’ah Audit” be carried out in Islamic Banks in Bangladesh?*** This question explains when and how far “Shari’ah Audit” will be used in Islamic Banks in Bangladesh.

***Hypotheses-4:*** *It was also hypothesized that the theoretical understanding and procedure of shariah auditing would be difference among the respondents.*

5. ***Should the Shari’ah Auditors audit neutrally and impartially?*** This question explains whether the shari’ah auditors should perform their duties without being influenced.

***Hypotheses-5:*** *It was assumed that the respondents would feel that shariah auditor would be independent in the institution they work for.*

6. ***Are the Islamic Banks in Bangladesh promoting shari'ah audit effectively?*** This question explores the role of Islamic Banks in Bangladesh in promoting shari'ah audit.

***Hypotheses-6:*** *It was assumed that the respondents would feel that the Islamic banks in Bangladesh are playing role properly in promoting shariah audit among the mass people.*

7. ***Should “Shariah Audit” be carried out along with “Shariah Review” in the Islamic Banks in Bangladesh? Will Shariah Audit be cost-effective?*** This question investigates whether there should be a proper shariah audit side-by-side shariah review. This question also investigates how far Shariah audit would be worth implementing by analyzing transaction and monitoring cost theory, principle-agent theory and residual claimant theory.

***Hypotheses-7:*** *It was also hypothesized that the Islamic banks in Bangladesh would not be interested to implement shariah audit along with shariah review because of the involvement of transaction cost, monitoring cost, principal-agent problem and residual claimants.*

## **1.5 Justification of hypotheses**

This research is an attempt of replicating the research conducted in Malaysia by (Hameed & Mulyany, 2007) and (Ibrahim, May 10, 2011). The context of Bangladesh is somewhat similar to the context of Malaysia. So the results of my present research would be somewhat similar to the results of the “*Shariah Audit for Islamic Financial Institutions (IFIs): Perceptions of Accounting Academicians, Audit Practitioners and Shariah Scholars*.” (Hameed & Mulyany, 2007) and Issues in

Shariah Auditing in Islamic Banking (Ibrahim, May 10, 2011).

## **1.6 Overview of the Methodology**

Both primary and secondary data were used in this research. For collecting primary data a survey questionnaire, with both ‘open-ended’ and ‘close-ended’ questions, was designed and distributed among the accounting academicians, audit practitioners and Shari’ah scholars in Bangladesh. A combination of quantitative and qualitative method was used to get the result. Frequency distribution method was used to examine the pattern of the respondents (Positivistic approach) and to interpret the views of the respondent’s hermeneutic approach was used. Holistic way of analysis and discussion is the expression of hermeneutic approach.

## **1.7 Need of Shariah Auditing Research**

1. The radical growth of Islamic banking and financial institutions in Bangladesh call for a suitable directions to carry out shariah auditing.
2. Almost all the commercial banks in Bangladesh are operating Islamic banking windows throughout the country to attract Muslims (90% of the population). So the Islamic banks in Bangladesh must establish a thorough and comprehensive audit to examine the shariah compliance.
3. In Bangladesh, there is a lack of empirical grounded research in the area of shariah auditing.
4. There are a lot of unsettled issues about the theoretical and practical aspects of shariah auditing in Islamic banks in Bangladesh.

## **1.8 Limitations of the study**

As the time was limited the research may not have been able to collect all the information from more respondents, which would have been helpful in drawing more precise results. This research focused on an idea, which is still incomplete (Shariah audit). As a result, the responses of all the respondents are all assumptions, not real fact.

## **1.9 Disposition**

*The disposition of the thesis is as follows:*

In the *introduction* chapter, the things that have been discussed are background, problem statement and research objective of the study. It also includes research questions, hypotheses and justification of hypotheses.

The *literature review* chapter starts with the difference shariah review and shariah audit. Then the importance of shariah audit as a separate discipline has been discussed. Research followed by the scope of shariah audit. Then the framework of shariah audit is described followed by, shariah auditor qualification and independence.

In the *methodology* chapter, the way the research has been conducted is described and the grounds for the chosen methods are stated.

In the *traditional and divine point of view* of auditing chapter, the concept of auditing from traditional and divine point of view has been discussed along with divine and ethical quality of an auditor.

In the *issues of shariah auditing* chapter definition, objective scopes and standards of shariah audit is described. Next, independence and qualification of shariah auditor have been mentioned. The process of shariah auditing and the basis of shariah auditing have been discussed followed by shariah audit report.

In the shariah framework chapter, the main feature of Islamic finance is described. While discussing shariah compliance, the prohibition of riba, gharar and Maysure have been covered.

In the *AAOIFI standards chapter*, accounting, auditing governance, and ethical standards of AAOIFI have been discussed. The chapter then introduces IFSB standards followed by the challenges of Islamic banks in their operations.

In the *shariah auditing as a professional approach* chapter, issues of shariah auditing: shariah governance, shariah review, internal shariah audit and external shariah audit have been discussed. In this connection a professional approach towards the above mentioned concepts have also been discussed.

In the *result analysis* chapter, the information collected through close-ended questionnaire have been discussed and analyzed in this chapter. For extracting results from the data frequency distribution method has been used.

In the *cost-benefit analysis* chapter, a cost-benefit analysis of implementing shariah audit has been discussed. For doing this economic theory of transaction and monitoring costs, agency theory and residual claimants theory have been analyzed.



In the *need of shariah auditing* chapter, the necessity of shariah audit in Bangladeshi Islamic banks is discussed.

In the *recommendation* chapter, the recommendations of the whole research are discussed.

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## Chapter-2: Literature Review

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*This chapter starts with the difference shariah review and shariah audit. Then the importance of shariah audit as a separate discipline has been discussed.*

*Research keeps an eye on the scope of shariah audit. Then the framework of shariah audit is described followed by, shariah auditor qualification and independence.*

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### 2.1 Shariah Review or Shariah Audit?

According to CPA Australia (2006), the term ‘Review’ is considered as a service through which the auditors deliver a reasonable level of assurance on the financial statements of an enterprise. They also mentioned that while audit provide a higher level of assurance, review provide an inferior level of assurance. (Ibrahim S. H., May 10, 2011). According to B.N Tandon (1999) cited in (Mohiuddin, Nov 9, 2012) Audit have two important aspects. One is examination and another is expression. The auditor should be independent to examine the financial statements of an enterprise. However, at the same time, auditor should express his independent opinion on the financial statements. To do so, auditor should comply with applicable legal obligation. Based on the above-mentioned definition there is a clear functional gap between review and audit. While ‘audit’ is considered as an engagement of reasonable assurance, ‘review’ is limited assurance engagement. In order to draw the decision of expression, ‘Audit’ is considered as optimistic. However, ‘Review’ is considered as pessimistic. On the other hand, in case of IFIs, AAOIFI defined “*Shariah review examines whether an IFI follows shariah in all its activities. The shariah review*

*examines the IFIs contracts agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc.”* The shariah review generally ensures whether IFIs is following the shariah and not doing anything, which goes against the shariah.

Carrying out the shariah review and expressing an opinion whether the IFI is following shariah compliance are the responsibilities of Shariah Supervisory Body. While the management of IFI is responsible for making the activities of the shariah compliant. Characteristics of this definition are:

1. The AAOIFI definition is comprehensive. While it says “all its activities”
2. It distinguishes between shariah review and shariah audit.
3. Shariah review gives lower level of assurance of compliance than shariah audit.
4. The shariah review may be appropriate of IFIs at their initial stage through the definition covers broader area.

There is a huge functional gap between AAOIFI Shariah Review standards and practice. Though the respondents of Shahul Hameed and Mulyani’s (2007) research approved of the AAOIFIs accounting and auditing standards, they also favored the use of the international standards because some of the AAOIFIs standards are incomplete, some others are old fashioned and some others are not included. For instance, the arrangement and selection of Shari’ah Supervisory Committee according to the GSIFI 1 is not detail about the responsibility of SSC. There is a confusion of “review” and “audit” in GSIFI 3 and reporting standard. There is an overlapping between the roles of internal auditing

department of Islamic banks and Shari'ah Supervisory Boards in conducting Shari'ah reviews and audits.

There are some similarities and dissimilarities between shariah review and shariah audit. While shariah review ensures only the ex-ante shariah compliance, shariah audit ensures both ex-ante and ex-post shariah compliance. The Islamic banks in house shariah supervisory committee carry out Shariah review. However, an independent professional body will conduct shariah audit. In case of shariah review, the work is very limited. On the other hand, the scope of shariah audit is much more wider and broader than shariah review. While shariah review fail to examine every aspect of Islamic banking, shariah audit scrutiny legal contracts, documents and operations in every aspect of Islamic banking according to Islamic principles and shariah. Sharish review check only shariah related issues on all the before task transaction. However, shariah audit check a thorough and comprehensive audit after executing the contracts.

## **2.2 “Shariah Audit” as a Separate Discipline**

In order to establish shariah auditing as an individual discipline, several issues have to be resolved. The first issue is a body of ‘knowledge and theory’ (Ibrahim S. H.). To do so tremendous amount of research has to be conducted to form this body of knowledge. According to (Hameed & Mulyany, 2007), majority of the respondents opined that shariah should be a separate and individual discipline. They also argued that there should also be a separated supervisory structure. In almost all the cases the members of Shariah Supervisory Committee have knowledge about shariah but they do not have training on conventional accounting procedures. Their advising role may conflict with their auditing role. However, the traditional accountants do not have proper shariah knowledge (Ibrahim S. H.). The combination is required here. A new discipline of shariah auditing should be established to create a new-fangled group of

shariah auditors who will have sound combined knowledge on western accounting systems and Islamic sharia (Ibrahim S. H.). The survey conducted by Shahul Hameed and Mulyany also found that majority of the respondents argued that in order to establish shariah audit as a separate discipline, a combination of Anglo American Accounting, auditing and Islamic Shariah is required.

It is the need of the time to establish shariah auditing as a separate discipline. While shariah scholars can derive shariah rules and principles for contemporary society, the western world should technical methodology for establishing shariah auditing as a discipline. One may ask a question that shariah audit will only be benefitted for the Muslim society only. The answer is that shariah audit as a separate discipline will not only be beneficial to Muslims society, but it also brings about a universal social welfare.

### **2.3 The Scope of Shari'ah Audit**

According to (Yaacob & Donglah, 2012) At the time of collecting evidence, the traditional auditor upholds an objective approach. So, the scope and area of traditional audit is incomplete and limited. However, shariah audit is well thought out as a societal function. So, it can be said that the scope of shariah audit is much more wider. Shariah audit covers a lot of other issues along with normal economic activities. For example, it covers social conduct and organizational functioning. It also covers connection of stakeholders with the business.

According to the survey conducted by (Hameed & Mulyany, 2007), the scope of shariah auditing is broader and should include: (a) Commercial plans (b) Procedures (c) Agreements (d) Financial systems and reporting (e) HRM (f) Charities (g) Ecological consequence of operations (h) Marketing (i) Public relations (j) Reports

(k) Zakat computation and disbursement (l) Information Technology Application systems etc.

## **2.4 Shari'ah Audit Framework**

The significance of emerging a good governance regarding shariah fulfillment matters have described by (Hameed & Mulyany, 2007) and (Grasis.W & Pellegrini.M, 2006) have identified the obstacle of shariah obedience procedure in the Islamic banking and IFIs. While focusing on the limitations of the present corporate governance within the IFIs, the study proposed an actual structure to check plus access the shariah compliance. There is no well-defined framework for directing shariah auditing in the Islamic Financial Institutions (IFIs). In practice, most of the IFIs are employing traditional audit framework to conduct shariah audit. However, majority of the respondents of (Kashim, Ibrahim, & Sulaiman, 2009) work cited in (Yaacob & Donglah, 2012) opined that shariah audit framework and traditional audit framework is totally difference from different aspects. However, a well-structured shariah infrastructure is helpful in maintaining the shariah compliance in the Islamic banks (Adawiah.E.R, 2007).

## **2.5 Shari'ah Auditor's Qualification**

According to (Shafii, Salleh, Hanefah, & Jusoff, 2013) *“in terms of competency quality in Shariah audit, the criteria of Shariah auditors shall be determined by IFIs at the institution's level. Shariah auditors must both have accounting and Shariah knowledge”*. They also mentioned that Islamic banks might send experienced staff to the shariah training center that do not have the qualification of both accounting and shariah. According to (AAOIFI, 2010), the qualifications of shariah auditors are: (1) shariah auditor should have knowledge on Islamic shariah, rules and principles. (2).

He should not have the same level of knowledge as Shariah Supervisory Body and (3) He should not also be entitled to interpret Islamic rules and principles. However, (Hameed & Mulyany, 2007) focused on a solid understanding on holly Qur'an and sunnah of Prophet Muhammad (S) should be the required qualification of shariah auditor. Majority of the respondents of their survey opined that shariah auditor should have the following qualifications: (1) shariah auditor must be a Muslim adult having a sound mind and empirical attitude (2) Shariah auditor must follow the region properly and have the ability to express opinion about the provisions and purposes of Islamic shariah (3) Shariah auditors must have a solid understanding of Sunnah (4) shariah auditors should be a sincere muslim, not a hypocritical (5) Speeches and actions of an shariah auditor must compliment one another and (6) Shariah auditor should be able to refuse gifts from employers and industries.

## **2.6 Shari'ah Auditor's Independence**

The term 'Auditor's independence' means the auditor perform their duties without being any influenced in the organization they work for. According to Kasim (2009) cited in (Yaacob & Donglah, 2012), the independence of shariah auditor is an important subject to ensure shariah properly. However, in real practice, the shariah auditors cannot escape some inevitable circumstances. At the same time, shariah auditors are not sure regarding their responsibilities. As a result, shariah auditor cannot attain its goals. To maintain Shariah compliance the shariah auditors should be independent. The independence of Shariah auditors has two aspects: mind and appearance. That means shariah auditor should be mentally as well as evidently independent.

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## **Chapter 3. Auditing: Conventional and Shari’ah Perspective**

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*Chapter three introduces the concept of auditing from conventional point of view origins and evolution of auditing and objectives of conventional auditing. Then auditing from Islamic perspective has been discussed along with the presence of shariah in shariah auditing.*

*Afterwards, ethical and divine quality of an auditor and qualities of an auditor from Islamic point of view have been detailed out. The chapter ends with comparative analysis between traditional and Islamic auditing.*

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Auditing is applied accounting. Conventional accounting has some rules, regulations and standards. In the same way conventional auditing has a framework of rules and regulations. If Shariah rules and regulations can be applied for constructing an audit framework it will guide the auditors to conduct Shariah auditing. Conventional auditing tries to see whether an organization prepares its financial statements following a “True and Fair View”. This information gives important to shareholders in different ways. If Shariah measurements are applied to conduct an audit then the audit will want to see whether an organization follows the rules and regulations given by the all mighty Allah.

### **3.1 Concept of Auditing**

The word Audit comes from a Latin word ‘Audire’. The meaning of ‘Audire’ is ‘to hear’. However, the modern concept of auditing focuses more on separation of ownership and control. The auditor scrutinizes the accounting information given by an organization and certifies it for the stakeholders (shareholders, Regulatory bodies,



Creditors, Investors, Researchers and Employees etc.) The accounting information are true. Shareholders use the audit report for various purposes.

### **3.2 Auditing from Conventional point of view**

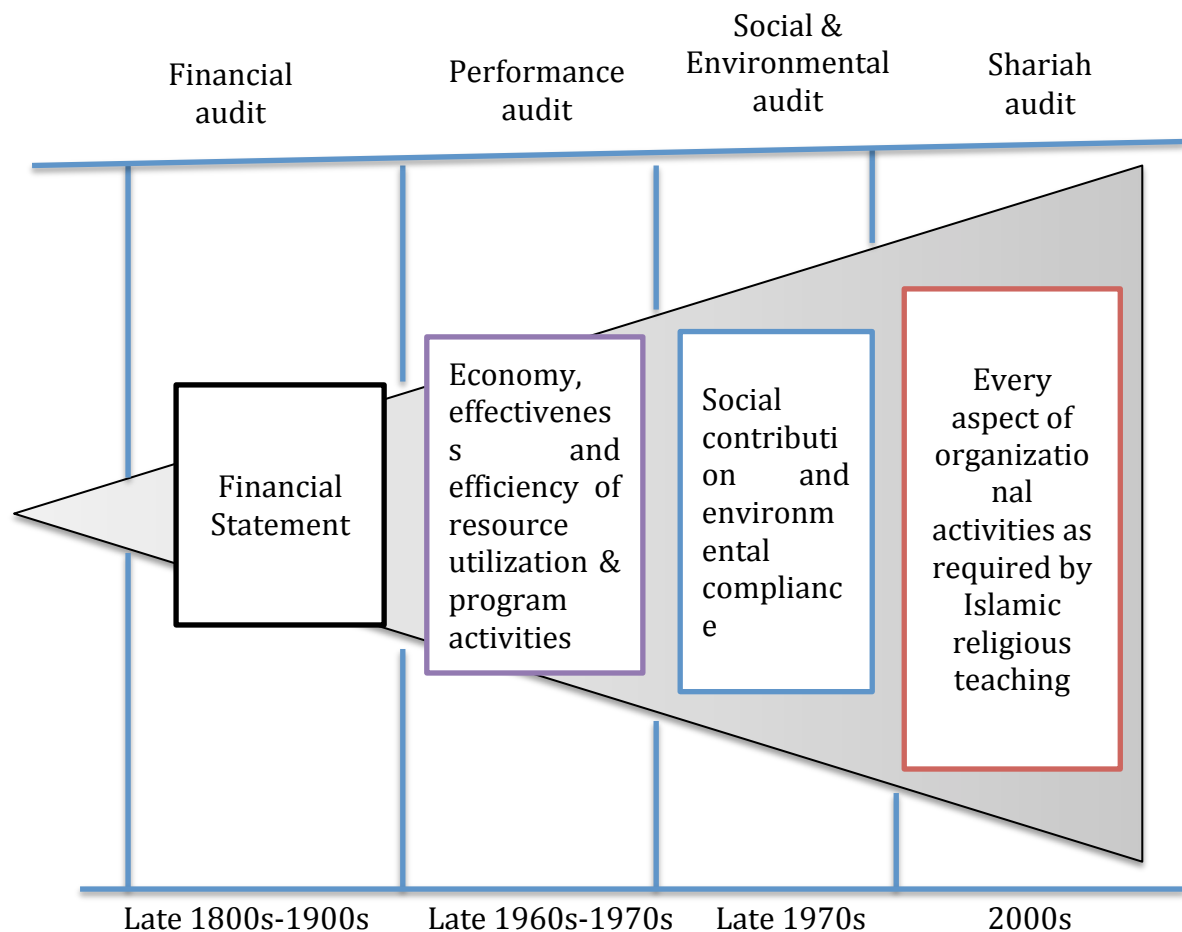
According to (Tandon, 1999) cited in (Mohiuddin, Nov 9, 2012), conventional auditing have four major characteristics:

1. The examinations are done independently
2. Independent examination is carried out to scrutinize financial information of an organization's financial statements whether the organization makes a profit or a loss is not the concern of auditing
3. The financial statements are verified to determine the accuracy and the reliability of it.
4. The audit expresses an opinion about the result of the auditing

### **3.3 Origins and Evolution of Auditing**

The first simplest form of auditing may have been used in Mesopotamian Civilization in 3600 B.C. The Egyptian also used auditing for goods disbursements. The Greek used audit for Government officials after their retirement. If we look into the Islamic history we see that detail accounting and auditing were used during the Caliphate of Umar (RA), which is known as 'Hisbah'. There were different designated persons who would receive pay and record cash, goods etc. during the Caliphate. In 14<sup>th</sup> Century, business became more critical and expanding. Along with barter system sole proprietorship and partnership evolved. The internal auditing first came into existence to audit the partnership business because not all partners were equally involved in partnership. The involvement of third party started at the same time. The Mayors of London and Dublin used to conduct audit. 18<sup>th</sup> Century shows the industrial

revolution, while joint stock companies started coming up. The Company Act 1994 in Bangladesh clearly defines the auditor's qualifications, scopes, responsibilities, power etc.



**Figure 3-1: Evolution of auditing**

Financial audit was commonly used in late 1800s and 1900s. In 1960s and 1970s performance audit flourished. It covered economy and good organization of resource consumption plans and actions. Later in 1970s social and environmental audit became prominent which took into consideration on social contribution and environmental compliance. In 2000s the idea of shariah auditing boomed. In shariah audit every aspect of financial organization's activities are under scrutiny according to the Islamic religious principles.

### 3.4 Objectives of auditing

Auditing is closely related to the intension of the management. So the objectives of the auditing are determined by the management assertions. However, audit has two basic types of objectives.

#### 3.4.1 Specific objectives

Specific audit objectives satisfy the necessity. Every audit has its specific situations. So the objectives of the audit should satisfy the requirements of respective situation. However, the specific objectives are a part of general audit objectives.

#### 3.4.2 General objectives

General audit objective focus on account balance. The general audit objectives are maintained all the time. To satisfy the general audit objectives, the auditors consider the following characteristics:

- a. Reasonability:** Before auditing an account balance the auditor develops an opinion about correctness and incorrectness of the records of that account. Before checking the account balance the auditors forms an overall opinion of the account. Depending on these assumptions an auditor designs the plan to audit that account (gathering evidence, required time ect.).
- b. Validity:** The auditor checks all the transactions whether they were valid transactions and therefore, they need to be present in the financial statement.
- c. Completeness:** The auditors must make sure that all valid transactions are recorded. If any valid transaction is not recorded, it remains incomplete. While validity scrutinizes whether all recorded transactions are valid transactions, completeness, scrutinizes that all valid transactions are recorded.

- d. Ownership:** The audit decides the ownership of assets and liabilities recorded in the financial statements. The recording of assets and liabilities depends on the assertions of the management about the assets and liabilities.
- e. Valuation:** The audit scrutinizes whether the values of assets and liabilities recorded in the financial statements are accurate.
- f. Classification:** The objective of audit is to see whether the accounts titles recorded in the financial statements are correct.
- g. Mechanical Accuracy:** The objective of audit is to check the mechanical accuracy of the details of the financial statement.
- h. Disclosure:** The objective of audit is to check whether all relevant information are prepared in the financial statements.

### **3.5 Auditing from Islamic point of view**

#### **3.5.1 The starting of Shariah Auditing -“Hisbah”**

Shariah auditing has emerged as a concept recently. The concept of ‘Hisbah’ has been originated from the Islamic concept of *“Ordering good and preventing the evil”*. ‘Hisbah’ started with the inception of Islam. It not only covers economic activities, but it also covers every aspect of social life. According to Islamic worshipping Allah have two dimensions: (1) following the duties towards almighty Allah. (2) Following the duties towards human beings.

#### **3.5.2 “Shariah” in Shariah auditing**

According to the AAOIFI, the term shariah compliance means Islamic rules; regulations and principles falling in line with fatwas and guiding principle give out by them. The definition is a bit contradictory because if the fatwas, rulings and guidelines do not cover all activities, “extent of shariah compliance in all its activities

cannot be reviewed”. As in practice Shariah Supervisory Board mainly issues fatwas about financial products. It does not always give fatwas about other activities, which makes AAOIFI’s definition contradictory. As the auditors themselves set criteria for auditing it threatens the independence of Shariah Supervisory Board by making it a “self review”.

Accountability to all mighty Allah (SWT) is the basic principle of Islam. If an auditor feels accountable to almighty Allah (SWT) and is afraid of the punishment Allah (SWT) will give if he does anything wrong. There is no scope for him to involve in any fraudulent activities. In the holly Al-Qur’an and Al- Hadith self-auditing is frequently evident. Allah (SWT) says, “Truly nothing is hidden from Allah (SWT), in the earth or in the heaven” (Al – Qur’aan, Sura Al – Imran – 5) cited in (Mohiuddin, Nov 9, 2012). Prophet (SAW) also said, “Judge yourself before you will be judged and weight your deeds before you will be weighted. (Jabnoun, 1994).” Cited in (Mohiuddin, Nov 9, 2012).

### **3.6 Ethical and divine qualities of an auditor**

#### **3.6.1 Qualities of an auditor form Ethical Perspective**

The behavior of human beings that is acceptable in the society can be defined as ethics. To make the auditing acceptable in the society the professionals follow certain ethical codes. Professional codes of ethics consider two basic things: general statement of acceptable conduct and specific guidelines for identifying unacceptable conduct.

*There are five principles of professional ethics:*

1. An auditor should be independent and objective. He should maintain

integrity while auditing.

2. The auditor must be able to follow the technical standard of the profession and he should continuously improve his competence of auditing.
3. While auditing the auditor should be fair and impartial. He should take care of the clients as much as his responsibilities allow.
4. An auditor must maintain a cordial relationship with other auditors.
5. As an auditor lives in a society of human beings he should maintain the public interest.

### **3.6.2 Qualities of an auditor form Islamic Perspective**

The auditor should follow “Code of Ethics for Professional Accounts” issued by AAOIFI. The responsibilities of an auditor according to Islam are:

1. **Morality:** An auditor has to be righteous.
2. **Honesty:** An auditor has to be trustworthy. The entire prophet had this quality.
3. **Professional Performance:** Hazrat Umar (RA) did not allow some people to conduct business because they did not have proper knowledge of running business.
4. **Fair-mindedness:** When working for another person, a firm or an institution, a person has to work efficiently and honestly.
5. **Ihsan (Proficiency and Efficiency):** Ihsan means doing extra than is required. Islam orders to give full effort and forbids negligence.
6. **Iklas (Sincerity):** If a person is not sincere, he will not be able to perform his duties properly. When a person is sincere, he will make sure that he gives the highest effort of his ability.
7. **Objectivity:** An auditor must know what and why he is auditing.

- 8. Professional Competence:** An auditor must be competent about auditing. He has to have proper education, training and sufficient guidelines.
- 9. Confidentiality:** The auditor must maintain confidentiality while auditing to make his audit effective.

### **3.7 Comparative Analysis between Traditional and Islamic Thought of Auditing**

“Auditing” has always been a key part in business organizations to ensure corporate governance. “Shariah audit” shares a parallel job but follows Islamic principles and rules on the compliance of Islamic banks and financial institutions. There are some similarities and dissimilarities of conventional auditing and shariah auditing. These are:

**Table 3-1: Conventional vs. Islamic Thought of Auditing**

<b>Element</b>	<b>Conventional Auditing</b>	<b>Shariah Auditing</b>
Three Party Relationship	(1) Entity (2) Auditor and (3) users	(1) Entity (2) Auditor and (3) Broader range of users
Suitable Subject Matter	Financial statements	Financial statements, process, contracts, personnel’s and performance
Appropriate Criteria	International Financial Reporting Standards (IFRS) standards	Islamic principles and rules, AAOIFI standard and relevant articles of IFRS
Adequate Appropriate Evidence	Observation, enquiry, physical examination, vouching of documents and	Analyzes SSC rulings, fatwas of international and national fiqh boards as well as all other

	minutes of directors meeting	conventional evidence
Written Pledge Report	Standard audit report prepared by auditor	A more detailed report prepared by a shari'a auditor.

Auditing is very important for any organization. If it is done efficiently and effectively, the position of the organization in the society is reflected. For auditing effectively and efficiently, the guidelines given by the Holly Qur'an and Hadith have to be followed. A person having the knowledge of both Qur'an and traditional auditing can perform this task well. Recently Islamic Financial Institutions are successfully expanding their business. Shariah auditing can play a very vital role here. But there is a need of proper knowledge of both auditing and Islamic Shariah together. A separate branch of knowledge has to be established where professional auditing and Qur'an and Sunnah will be taught. Everywhere there should be "God Fearing Approach" among everyone concerned.

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## **Chapter-4: Issues of Shariah Auditing**

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*Chapter four define shariah audit and describes objective scopes and standards of shariah audit. Next, independence and qualification of shariah auditor have been mentioned.*

*The process of shariah auditing and the basis of shariah auditing have been discussed followed by shariah audit report. A comparison between shariah audit and conventional audit is presented along with challenges of implementing shariah audit.*

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### **4.1 What is Shariah Audit?**

#### **4.1.1 General Definition**

Shariah audit follows shariah principles. After collecting and evaluating sufficient and reliable information about the activities of an IFI, the shariah audit reports its conclusion and opinion to the appropriate authority.

#### **4.1.2 General Scope**

The shariah audit includes not only the financial transactions of an IFI but it also scrutinizes policies and operation procedures of that IFIs.

### **4.2 Definition of Shariah Audit**

As there is no clearly defined Shariah audit in practice and there is a dearth of literature on this topic, Shariah audit has not yet been clearly defined. However, within the existing definitions of Shariah audit the AAOIFI's Governance Standards No. 2 (GSIFI 2 of AAOIFI) is the most comprehensive and says "*Shariah review examines whether an IFI follows shariah in all its activities. The shariah review*

*examines the IFIs contracts agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc.”* The shariah review generally ensures whether IFIs is following the shariah and not doing anything, which goes against the shariah. Carrying out the shariah review and expressing an opinion whether the IFI is following shariah compliance are the responsibilities of Shariah Supervisory Body. While the management of IFI is responsible for making the activities of the shariah compliant. (Sultan, 2007).

### **4.3 Characteristics of Shariah Audit**

*Shariah auditing has four major characteristics:*

1. Shariah audit is considered as social function and its scope is much more wider.
2. Financial statements should be prepared in harmony with ruling guideline hand out by SSC.
3. AAOIFI standard, international and national auditing standard and practice should also be followed at the time of preparing financial statements of Islamic financial institutions.
4. Shariah auditor shall have proper knowledge about Islamic rules and principles.

### **4.4 Objectives and Scopes of Shariah Audit**

#### **4.4.1 Objective**

The main objective of Shari’ah audit is to ensure shariah compliance. The Islamic banking should follow Islamic Shari’ah moralities in all its activities, transactions, products, services, policies, process and procedures.

#### 4.4.2 Scopes

Though the term shariah is very broad, at present the Shariah Supervisory Board (SSB) considers a very narrow view of it regarding the technical compliance of financial contracts. The shariah auditing discusses: (a) Business plans (b) Procedures (c) Agreements (d) Financial systems and reporting (e) HRM (f) Charities (g) Environmental effect of operations (h) Marketing (i) Public relations (j) Reports (k) Zakat computation and disbursement (l) Information Technology Application systems etc. (Sultan, 2007) mentioned the scopes of Shari'ah auditing in Islamic bank into four sections:

1. Financial Statements Audit: The Shari'ah auditing reviews the financial statements of an Islamic bank to see that the statements were reported following the standards revealing in the country and the standards of the Shari'ah auditing.
2. Operational Aspects of Islamic Banks: Shari'ah audit examines the types of business an Islamic bank is involved in. It includes (1) Policies and procedures of an Islamic bank activities; (2) Operation procedures; (3) Contracts; (4) Memorandum of Articles of Association and (5) Scrutinizing the reports issued by the Shari'ah Supervisory Council (SSC).
3. Organizational Structure and personnel Management: The next scope of Shari'ah audit in an Islamic bank is the organizational structure and personnel management of the Islamic banks. This ensures that an Islamic bank is competent enough to carry out Islamic Shari'ah compliant business having the proper organizational structure and qualified workers.
4. Information and Technology Systems: The Shari'ah audit should also cover the Information Technology (IT) application systems of Islamic banks. This is quieting

important to see whether Islamic banks have proper Information Technology and other modern technologies for doing business following the Islamic Shari'ah.

#### **4.5 Shariah Auditing Standards**

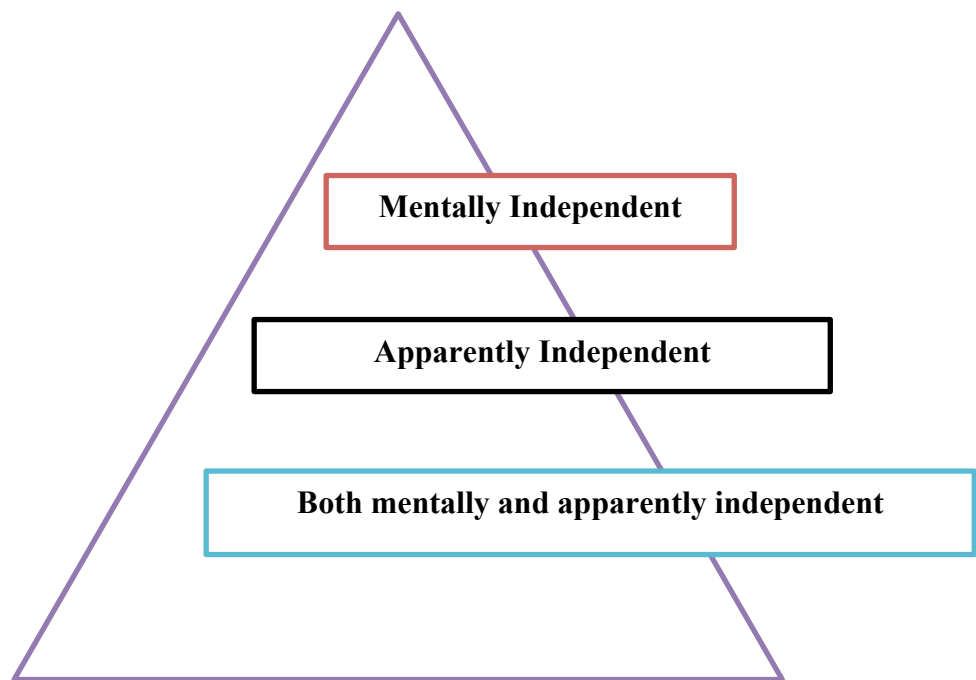
The steady growth of IFIs depends on establishing a proper shariah auditing standards. Without having a proper shariah auditing standards may disasters the future growth if IFIs. Conventional auditing has some internationally accepted standards like IAS, IAASB etc. However, Shariah auditing does not have such kind of universally accepted standards. At present, AAOIFI standards and IFSB standards are the best available standards for shariah auditing. However, the problem is that they are not uniquely. In order to establish an internationally accepted shariah auditing standards, tremendous amount of empirical research needs to be conducted.

Interest is main earning source of commercial banks. However, Islamic banks ignore interest completely. This is because it is Quranic order. The holly Quran completely prohibits interest. So it can be said that Islamic banks is totally different form conventional banks in regards with interest. Islamic banks face several additional challenges along with all challenges faced by conventional banks. These include shariah compliance related challenges. That means, Islamic banks should be free from riba, gharar and maysir based transactions. Islamic banks also faced pressure from stakeholders. This is because, the people transacting with Islamic banks needs to ensure that, IFIs are operating by following Islamic shariah properly. On the other hand, there are no universally accepted auditing standards of Islamic banks like conventional banks.

## 4.6 Independence and Qualification of Shariah Auditor

### 4.6.1 Independence

The SSC is an independent external audit body for the Islamic banks. The SSC maintains the shariah compliance in the Islamic banks by directing, supervising and reviewing the activities of these banks.



*Figure 4-1: Independence of shariah auditor*

To maintain Shariah compliance the shariah auditors should independent. The independence of Shariah auditors has two aspects: mind and appearance. A shariah auditor has to be mentally objective while auditing to avoid human errors. On the other hand, he has to be apparently independent.

### 4.6.2 Qualification

In almost all the cases the members of Shariah Supervisory Committee have knowledge about shariah but they do not have training on conventional accounting

procedures. Their advising role may conflict with their auditing role. However, the traditional accountants do not have proper shariah knowledge. The combination is required here. A new discipline of shariah auditing should be established to create a new group of Islamic auditors who will have following sound knowledge of both western accounting systems and Islamic sharia.

1. Must be a Muslim adult having a sound mind and impartial attitude: To be a shariah auditor, a person has to be a practicing Muslim. He must be mentally and physically sound. To carry out his responsibility properly a shariah auditor must have an impartial attitude.
2. Must follow the religion properly and have the ability to express opinion about the provisions and purposes of Islamic shariah: A shariah auditor must follow the rules and regulations of Islam properly. He should be able to express opinions about different aspects of the religion. He should have the ability to explain different provisions of Islamic Shariah.
3. Must have a solid understanding of Sunnah: A shariah auditor must have a sound knowledge of 'Hadith'. He should have the ability to identify proper Sunnah and follow it
4. Should be a sincere Muslim, not a hypocritical: A shariah auditor must be a honest man in his personal life. He has to be a man of word. He should not be hypocritical. He should be a true and just Muslim.
5. Speeches and actions of an auditor must compliment one another: A shariah auditor must do what he says. There should not be any discrepancies between his words and actions.

6. Should be able to refuse gifts from employees and industries: A shariah auditor must not accept any gift from anybody who is related to the institution being audited. He should have the ability to refuse the gift of any form.

#### **4.6.3 Managerial competence and training to conduct shariah audit**

While conducting the research, I carried out open-ended interviews with the respondents, which threw light on some important aspect of managerial competence and training to conduct shariah audit. Majority of the respondents opined that shariah auditor should have solid background on Anglo-American Accounting and Auditing system and Islamic rules, regulations and principles. They argued that as there is a dearth of expertise to conduct shariah audit Islamic banks might hire shariah scholars to conduct shariah audit as a helping hand of internal shariah review unit. They also argued that Islamic banks in Bangladesh might send experienced staff to the shariah training center that do not have the qualification of both accounting and shariah. Majority of the respondents of audit practitioners and accounting academicians opined that Shariah auditors must be trained on a lot of other issues along with normal economic activities. It should include: a) Business plans (b) Procedures (c) Agreements (d) Financial systems and reporting (e) HRM (f) Charities (g) Environmental effect of operations (h) Marketing (i) Public relations (j) Reports (k) Zakat computation and disbursement (l) Information Technology Application systems etc.

#### **4.6.4 Neutrality in facing corruption**

There are no rules and regulations for conducting shariah audit in Bangladeshi Islamic banks now. However, if there were rules they would have been violated because of omnipresent corruption. Overcoming corruption, the neutrality of the

shariah auditors could be mentioned only when everyone related to shariah audit is religiously and morally committed.

#### 4.7 The Procedures of Shariah Auditing

Shariah audit procurer can be considered as a cycle having three stages:

1. Planning review procedures.
2. Executing review procedures and preparing working papers.
3. Documenting conclusions and reporting to shareholders.

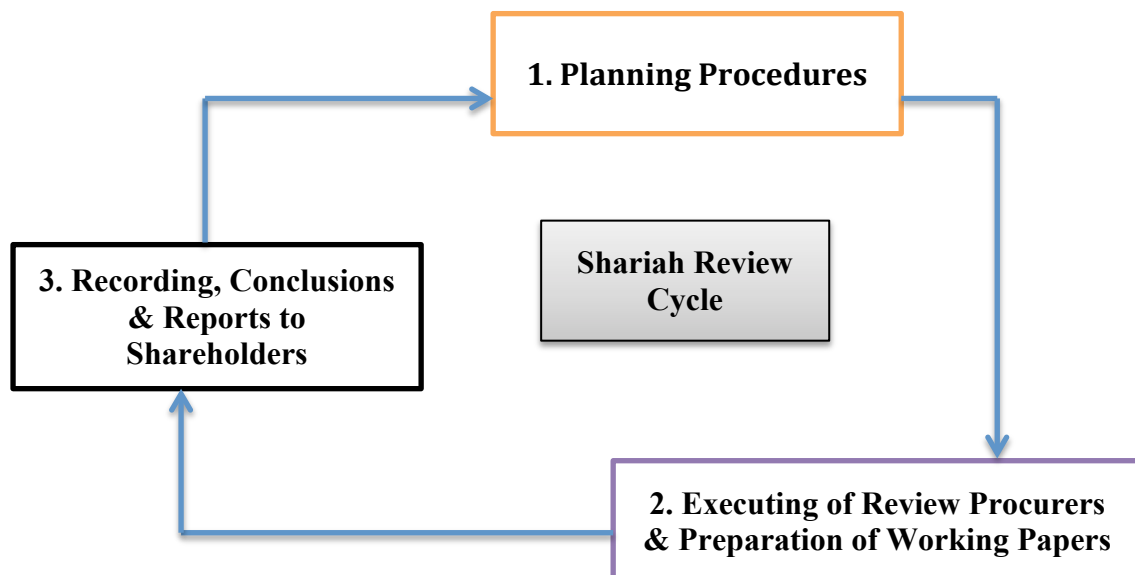


Figure 4-2: Shariah Auditing Procedures

**Stage 1: Planning reviews procedures:** At this stage review procedures should be planned. Review procedure includes a lot of tasks, which should be planned before hand to make it accurate and effective.

**Stage 2: Executing reviews procedures and preparing working papers:** At this stage of the plan of review procedures should be executed. After the execution of the planned review activities the planned review procedures should be documented in working papers.



**Stage 3: Documenting conclusions and reporting to shareholders:** Depending on the working papers the Shariah Supervisory Body will draw conclusions and prepare report for the shareholders.

## **4.8 Shariah Audit Reports**

GSIFI 1 of AAOIFI prescribes the standard form of shariah audit report that the Islamic banks should follow. The form is almost like the long form American audit report. The shariah audit report must consider both the methodology of gathering audit evidence and the findings of a number of issues related to the scope of shariah report. The shariah audit report should include: (1). The objective of the shariah audit (2) Process and procedures taken in performing the shariah audit (3) Findings (e.g. detailed breach and violation of shariah principles by IFIs). (4) Implications. (5) Recommendations for improvements. (Ibrahim S. H.).

It is the need of the time to establish shariah auditing as a separate discipline. While shariah scholars can derive shariah rules and principles for contemporary society, the western world should technical methodology for establishing shariah auditing as a discipline. Once established, shariah auditing will not only be beneficial to Muslims society, but it also brings about a universal social welfare.

### **SHARIAH AUDIT REPORT**

In the name of Allah, The most Gracious, The most Merciful.

To the Shareholders of The XYZ Islamic Bank

Assalam Alaikum Wa Rahmat Allah Wa Barakatuh

According to the terms and conditions mentioned in the letter of appointment, the report is being presented: The operation principles, contracts and transactions of all

kinds were scrutinized during the period under audit. We have reviewed everything of XYZ Islamic Bank to form an opinion whether XYZ Islamic Bank act in harmony with Islamic shariah and abide by the fatwas, rules and guiding principle issued by us. It is important to note here that, the management of the XYZ Islamic Bank is solely responsible to maintain shariah compliance in all their activities. However, our responsibility is to form an independent opinion on the basis of our review by checking every single transaction and report to you.

In our opinion:

1. We have reviewed all the contracts, agreements and transactions made by the XYZ Islamic Bank in accordance Islamic shariah and principles.
2. We have reviewed the distribution of profit and loss to the depositors according to Islamic shariah and principles.
3. We have reviewed the earnings from prohibited activities goes to the charitable sectors or not.
4. We have reviewed the zakat calculation and payment according to Islamic shariah and principles.

We ask almighty Allah to give us success and to be straightforward.

Name and signature

Members of Shariah Supervisory Committee

Place and Date

#### **4.9 Similarities and dissimilarities between conventional audit and shariah audit**

“Auditing” has always been a key part in business organizations to ensure corporate governance. “Shariah audit” shares a parallel job but follows Islamic principles and rules on the compliance of Islamic banks and financial institutions. There are some similarities and dissimilarities of conventional auditing and shariah auditing.

1. **Three Party Relationship:** In both the auditing system three parties are involved: (1) Entity (2) Auditor and (3) users. But in case of shariah auditing the range of users become much broader.
2. **Suitable Subject Matter:** While conventional audit focuses financial statements, shariah audit analyzes the process, contracts, personnel's and performance along with financial statement.
3. **Appropriate Criteria:** While conventional audit follows International Financial Reporting Standards (IFRS) standards, shariah auditing follows Islamic principles and rules, AAOIFI standard and relevant articles of IFRS.
4. **Adequate Appropriate Evidence:** The evidence collected and analyzed by conventional audit are observation, enquiry, physical examination, vouching of documents and minutes of directors meeting. The shariah auditing collects and analyzes SSC decisions, fatwas and other conventional evidence.
5. **Written Pledge Report:** Conventional auditors carry out both the audits, but in case of shariag auditing they take help and guidance from Shariah Supervisory Committee (SSC).

#### **4.10 Challenges in Implementing Shariah Audit**

Shariah auditing in Islamic banking includes collecting evidence and reporting about the activities of the Islamic banks whether they are done following the Islamic Shariah. A skillful, independent and competent auditor should do this auditing. There must be some establish criteria depending on which the auditor can audit an Islamic bank. The Shariah auditor audits from objective (Financial information) and subjective (Shariah information) aspects of Islamic banking to ensure Shariah compliance.

Shariah Audit Evidence: Collecting audit evidence is the first challenging task of a Shariah auditor. Shariah audit evidence is basically any information, which the auditor uses to scrutinize whether the Islamic bank being audited is following Islamic Shariah principles properly. The evaluation of information depends on the nature of information. The criteria for evaluating of subjective information can be set mutually by the authority of the Islamic bank being audited and the auditor. However, the auditor may follow the written guidelines of Shariah Supervisory Committee (SSC).

For Shariah audit, information is collected to see whether the Islamic bank is following the Shariah principles. Different forms of information may be used: written communication between the bank and its clients, oral testimony of the auditee, auditor's observations, electronic information about transactions etc. The auditors must collect as much information as is sufficient to determine whether the bank is following Islamic Shariah.

Shariah Audit Procedure: Developing a systematic and thorough audit program is a critical issue in Shariah auditing. If the procedures for auditing are written as a list it may be considered as a Shariah audit program. For legal documentation and operational procedures, there should be a separate Shariah audit program. An audit program scrutinizes a particular area of audit.

Shariah Audit Education: There is a crisis of competent and independent Shariah auditors. To audit an Islamic bank a Shariah auditor needs at least two different qualifications: (1) qualification for carrying audit following conventional audit standards and (2) Proper knowledge on Islamic Shariah. The combination of these two qualifications is very rare. However, the Shariah auditor must have an independent mind. To create professional Shariah auditors by giving education and training on both auditing and Islamic Shariah, there is no institution as yet. To

establish Shariah auditing as a separate profession an institution must be there which trains and equips the Shariah auditors with two basic qualifications: (1) Shariah knowledge about applied Islamic Banking and Finance (2) Accounting and Auditing skills. Both Shariah scholars and accounting practitioners can join this institution. This institution will play a vital role in establishing Shariah auditing as a separate and individual profession in future.

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## Chapter-5: Shariah Auditing Standards for IFIs

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*Chapter six presents the standards of AAOIFI, which include accounting, auditing governance, and ethical standards of AAOIFI. The chapter then introduces IFSB standards followed by the challenges of Islamic banks in their operations. The chapter finishes with an effort of making Islamic banking more reliable.*

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### 5.1 Standard setting bodies for Islamic Financial Institutions

Whether the Islamic banks follow Islamic Shari'ah principles properly will ensure the steady growth of Islamic finance. It depends on establishing an exact procedure of Shari'ah auditing. If the standards of Shari'ah auditing can be precisely set following the Islamic Shari'ah principles, it will guarantee the growth. (Abdel-Karim, 1999).

**Table 5-1: Standard Setting Bodies in Islamic Finance**

Name	Description	Country	Website
<b>AAOIFI</b>	The AAOIFI started its journey in the year 1990 in Algiers. It is now Bahrain based organization. The main aim of AAOIFI is to establish accounting, auditing, governance as well as ethical standards for IFIs	Bahrain	<a href="http://www.aaoifi.com">www.aaoifi.com</a>
<b>IFSB</b>	IFSB establish in office on Nov. 2002. It works as a regulatory and supervisory body for IFIs. Its main objective is to set standards to ensure transparency in the IFIs	Malaysia	<a href="http://www.ifsb.org">www.ifsb.org</a>
<b>MASB</b>	The Malaysian Accounting Standards Board's (MASB) is a Malaysian based standard setting body for Islamic Financial Institutions. The main objective of MASB is to set financial reporting	Malaysia	<a href="http://www.masb.org.my">www.masb.org.my</a>

	standards in accord with AAOIFI.		
<b>IIFM</b>	The International Islamic Financial Market (IIFM) establishes office in Bahrain. The principal aim of IIFM is to campaign for trading of Islamic financial instrument in the secondary market by following Islamic shariah.	Bahrain	<a href="http://www.iif.net">www.iif.net</a>
<b>IIRA</b>	The Islamic International Rating Agency (IIRA) is well known as credit rating agency. However, at the same time it also keeps shariah compliance rating among Islamic financial institutions.	Bahrain	<a href="http://www.iirating.com">www.iirating.com</a>

Source: websites listed in the table and (Hayat, Butter, & Kock, not mentioned)

## 5.2 Accounting, Auditing, Governance and Ethics Standards of AAOIFI

The AAOIFI sets 12 Accounting standards, 5 auditing standards, 7 governance standards and 2 ethical standards in order to establish shariah auditing as separate and individual discipline ([www.aaofii.com](http://www.aaofii.com)) .

### 5.2.1 Accounting Standards

#### *Financial Accounting Statements*

1. Objective of Financial accounting of Islamic Banks and Financial Institutions
2. Concepts of Financial Accounting for Islamic banks and Financial Institutions

Source: (Abdel-Karim, 1999) and ([www.aaofii.com](http://www.aaofii.com))

#### *Financial Accounting Standards*

1. General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions.
2. Murabaha and Murabaha to the Purchase Orderer.

3. Mudaraba Financing.
4. Musharaka Financing.
5. Disclosure of Bases for Profit Allocation Between Owners' Equity and Investment Account Holders.
6. Disclosure of Bases for Profit Allocation Between Owners' Equity and Investment Account Holders.
7. Equity of Investment Account Holders and Their Equivalent.
8. Salam and Parallel Salam.
9. Ijara and Ijara Muntahia Bittamleek.
10. Zakat
11. Istisna' and Parallel Istisna'

Source: (Abdel-Karim, 1999) and (www.aaofi.com, 2010)

### 5.2.2 Auditing, Governance and Ethics Standards of AAOIFI

<b><u>Auditing Standards</u></b>
1. Objective and Principles of Auditing
2. Auditors Report
3. Terms of Audit Engagement
4. Testing for Compliance with Shari'ah Rules and principles by an External auditor
5. The Auditor's responsibility to Consider fraud and Error in an Audit of Financial statements
<b><u>Governance Standards</u></b>
1. Shari'ah Supervisory Board: Appointment, Composition and Report
2. Shari'ah Review
3. Internal Shari'ah Review
4. Audit and Governance Committee for IFIs
5. Independence of Shari'ah Supervisory Board
6. Statement on Governance Principles for IFIs
7. Corporate Social Responsibility



<b><i>Ethics Standards</i></b>
1. Code of Ethics for Accountants and Auditors of IFIs
2. Code of Ethics for Employees of IFIs

Source: (Abdel-Karim, 1999) and (www.aaoifi.com, 2010)

### **5.3 Challenges of Islamic Banks in operations**

Interest, on which the conventional banking runs, is prohibited in Islamic Shariah. So Islamic banking is completely different from conventional banking. The challenges of conventional banking are also the challenges of Islamic banking along with Shariah compliance related challenges. In Islamic banking the accounting academicians, practitioners and professional face Islamic Shariah related issues other than Western theories and practices. The shareholders and account holders of Islamic banking requires more from the auditors of Islamic banking than from the auditors of conventional banking because they want to be certain about the Islamic compliance.

There is no universally acceptable Shariah principle for operating Shariah audit in Islamic Financial Institutions. This reality forces Islamic Banks to establish their own internal Accounting and Shariah based Auditing System. This system is usually established to work as lasso between the external auditor and the management and is also work with the Shariah Supervisory Borad (SSB). This system mainly investigates whether the existing standards follow shariah. Whenever any existing standards contradict with the Islamic shariah principles, this system finds an alternative suggestion for following Islamic Shariah properly.

As an individual Islamic bank has an individual system mentioned above, there is no harmony the accounting practices among the Islamic banks. For instance, different banks have different ways of calculating profit of Murabaha transactions. Even some

Islamic banks calculate Murabaha profit in different ways in the same financial year. There are different method of calculating profit of account holders and shareholders in different Islamic banks. Other operations of Islamic banks also have variations. These variation occur mainly because there are no uniquely followed common standards for operating Islamic banks, preparing financial statements, Shariah auditing etc.

#### **5.4. Making the Islamic Banking more reliable**

If the general people are ensured of the Shari'ah compliance of the activities of interest-free banking, people will rely more on these institutions. To do this three strategies have to be follow:

1. A unique set of standards for auditing interest-free banks following the Islamic Shari'ah principles strictly have to be developed.
2. The improved management, policies of operations and recruitment in the interest-free banks must assure the overall people of Shari'ah compliance.
3. The existing Islamic Banking and Financial Institutions should maintain a Shari'ah compliance rating of the Islamic Banking and Financial Institutions and their products and services.

As there is no standardized financial reporting system for Islamic Financial Institutions the Accounting and auditing practices of different Islamic banks are different. As Islamic Finance Industry is growing very rapidly it has become very necessary to develop a unique Auditing standards for interest-free banks all over the world. The Bahrain based AAOIFI is playing the major role in developing and promoting these unique standards for Shariah Accounting and Shariah Auditing. This

institution, in collaboration with Shariah Board, has so far laid out eighteen pronouncements on Islamic Accounting and Auditing standards.

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## Chapter-6: Shariah Audit-The Shariah Framework

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*This chapter elaborates the main features of Islamic finance. While discussing shariah compliance prohibition of riba, gharar and Maysir have been covered.*

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### 6.1 The salient feature of Islamic finance

There are four noticeable features of Islamic finance. Involvements in haram activities are completely prohibited in Islamic finance. In Islamic finance profit or loss should be share equally by both parties. There should be no scope for uncertainty and condition in a contract. Islamic finance prohibits the production of wine and swine meat.

1. **Avoiding sinful activities:** Islamic Shari'ah prohibits sinful activities. So, involvement in prohibited activities is prohibited in Islamic finance. Examples of these prohibitions are interest (riba) based transactions, uncertain transaction conditions and involvement in production and consumption of haram (prohibited) products.
2. **Sharing risk:** In Islamic finance both the parties share risk of profit and loss equitably. All the contracts in Islamic finance follow this principle.
3. **Exploitation free:** In Islamic finance there is no room exploitation. Both the parties of a contract are exactly clear about their rights, liabilities and obligations of the contract. There is no scope of any uncertainty and the conditions of a contract should be prepared by mutual understanding of the parties.
4. **Humanitarian and productive purpose:** Islamic finance promotes social wellbeing and economically productive sectors. So, Islamic finance prohibits

involvement in the production of wine and swine meat, which are haram (prohibited) in Islamic Shari'ah because they have negative impact on the society.

## **6.2 General shariah compliance**

### **6.2.1 Prohibition of Riba**

The dictionary meaning of riba is growth. In modern economics riba is understood by the word interest. The riba or interest occurs when there is a financial transaction between two parties in two different times an additional amount is added. In economics it is explained by the theory of 'Time value of money'; time lapses, the value of the money goes down and the amount of money increases. This is very normal and is the basis of modern economics. In modern banking riba accrues at both ends. When the bank collects deposits from a client it promises to give additional amount (riba) after a certain time. When a bank gives loan to a client it also charges riba (interest / additional amount) from the client. In Islamic finance the additional amount comes from risk sharing of the transaction. In modern economics the riba or interest is fixed depending on time and one party is bound to give other party the additional amount. In Islamic finance both the debtor and lender share the profit or loss.

### **6.2.2 Prohibition of Gharar**

The term gharar can be explained as a sale of products when the goods are not at hand. For example, sale of fish in the sea. In Islamic there is no scope for uncertainty and condition in a contract. That means one party cannot get undue advantage over another. The Holy Quran also prohibits gharar-based contract. According to (Sultan,

2007), gharar can be explained as a sale of a product when the goods are not present at hand.

### **6.2.3 Prohibition of Maysir**

Maysir is a synonym of Gambling. It is prohibited in Islamic finance because the Holly Qur'an prohibits it. The reason why maysir is prohibited is also explained in the Holly Qur'an. A party may gain undue advantage over the other in this type of contract but an enmity and hate red will grow between the parties.

### **6.2.4 Prohibition of Involvement in Sinful (Haram) products**

Dealing with the haram products is also prohibited in Islamic finance. The examples of haram products can be pornography, wine or alcoholic products, swine head or its derivatives and other haram products. In Islamic finance interest incurring financial assets like bonds and debt securities, shares of the companies involved in prohibited trades are also prohibited.

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## **Chapter-7: Shariah Auditing: Need of Professional Approach**

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*Chapter seven talks about a few issues of shariah auditing: shariah governance, shariah review, internal shariah audit and external shariah audit. In this connection a professional approach towards the above mentioned concepts have been related.*

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### **7.1 Need of Professional Approach in Shariah Audit**

One of the most important challenges accepted by interest-free banks is full compliance of shariah rules, regulations and principles in all their activities to make it more transparent and disciplined. The failure of establishing shariah compliance prompts the reputation risk as well as instability of Islamic banks (Onagun & Mikail, 9 February, 2013). So, in order to reduce reputation risk and instability of Islamic banks, a professional approach is required. The professional approach is needed to analyze both ex-ante and ex-post compliance in Islamic shariah. The ex-ante compliance in Bangladeshi Islamic banks is basically the SSC's supervision, monitoring and controlling during the banks' operation and after operation. This is done to ensure shariah compliance in the banks' dealings and business. However, ex-post shariah compliance is very rare in Bangladesh. To ensure the ex-post shariah compliance, a specialized professional approach is needed. It requires a thorough and comprehensive audit by external professionals to scrutiny the transactions of the bank after the execution of contracts.

With due respect to all shariah scholars in Bangladesh, who have performed a main duty in developing the Islamic banks and establishing Islamic shariah, it was observed that they have not yet undertaken any internationally accepted exams on their trustworthiness and integrity as is usually taken by conventional professional

accountants which is structured by their corresponding professional bodies and guaranteed by particular professional ethics. It can be said undoubtedly that this is not the fault of the Shariah scholars, as there are no lawful obligations for them to be a professional.

## 7.2 What is Shariah Governance?

One of the most important areas in Islamic business is shariah governance. It determines the shariah compliance of Islamic Financial Institutions. According to IFSB-10, Shariah governance can be defined as *“a set of institutional and organizational arrangements through which a IFIs ensures that there is effective independent oversight of shariah compliance over the issuance of relevant shariah pronouncements, dissemination of information and an internal shariah compliance review”* (IFSB-10, December,2009) cited in (Onagun & Mikail, 9 February, 2013).

If we explain the above-mentioned definition in the light Bangladeshi Islamic Banks model then we found that this definition exemplifies the duties and responsibilities of Shariah Supervisory Committee (SSC) of respective Islamic banks in Bangladesh. This definition also suggests that SSC is a crucial part of shariah governance system. The following table shows the shariah governance accompaniments of IFIs.

**Table 7-1: Shariah Governance Framework**

Functions	Typical Financial Institution	Exclusive to IFIs
Governance	Board of Directors	Shariah Board
Control	Internal Auditor/ External Auditor	Internal Shariah Review Unit/ External Shariah Review Unit
Compliance	Regulatory and Financial Compliance Officers, unit or	Internal Shariah compliance



	department	unit
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Source: (Onagun & Mikail, 9 February, 2013)

### **7.3 Internal Shariah Review**

The internal shariah review is an independent department in the respective Islamic bank and the members of this section are appointed by the Shariah Supervisory Committee to monitor the day-to-day shariah compliance in all its operations and transactions. To ensure shariah compliance in all its activities, the members of internal shariah review should have solid knowledge on the Islamic shariah. The internal shariah review submits their report to the Shariah Board / Shariah Supervisory Committee with suggestions to the administration of the interest-free banks to report and rectify any problems of shariah compliance.

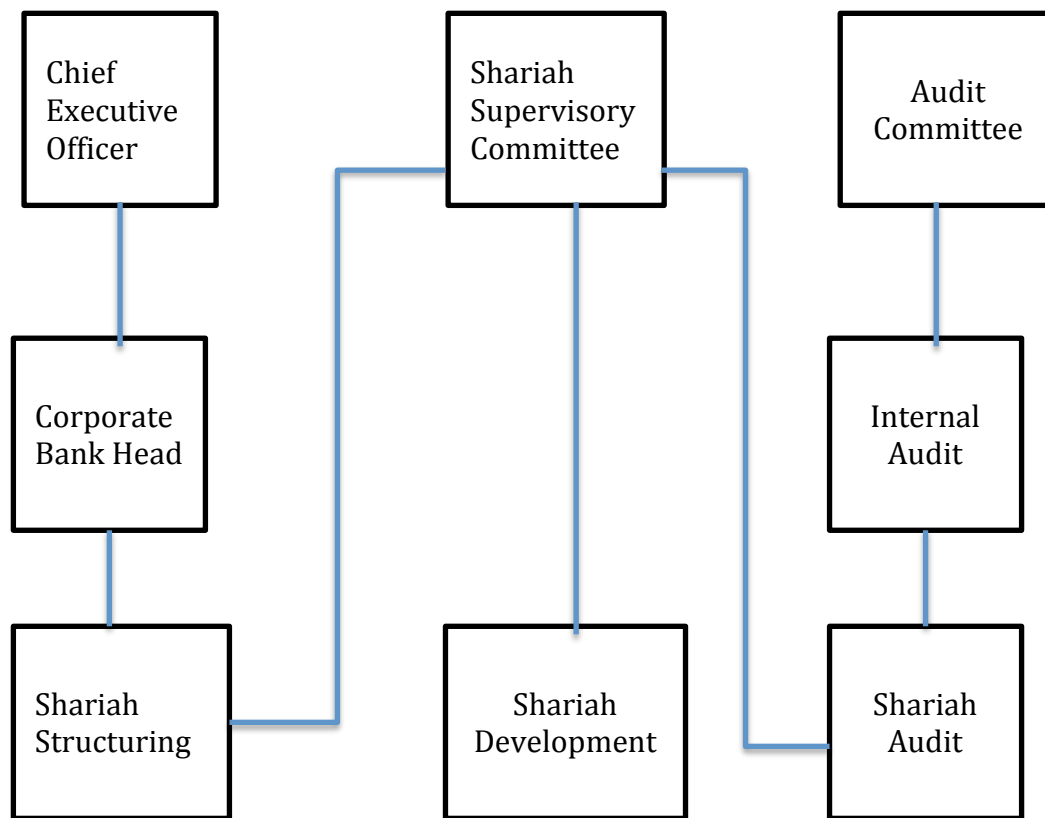
### **7.4 Internal Shariah Audit**

The ex-ante shariah compliance in Bangladeshi Islamic banks is mostly the internal shariah audit unit's supervision, monitoring and controlling during the bank's operation and after operation. This is done to ensure shariah compliance in the bank's dealings and business. In practice, the internal auditors submit the audit report to the audit committee with suggestions to the administration of the interest-free banks to report and rectify any problems of shariah compliance.

### **7.5 External Shariah Audit**

An annual thorough and comprehensive audit by Shariah Board/ Shariah Supervisory Committee (SSC) to scrutiny the transactions of the bank after the execution of contracts. Alternatively, the SSC may appoint an external professional auditor to

conduct this similar kind of task. The following diagram shows a summarized shariah audit structure.



Source: The World Bank cited in (Onagun & Mikail, 9 February, 2013)

**Figure 7-1: Shariah Audit Structure**

## 7.6 Explanation of professional approach

The (IFSB, 2008) conducted a survey focusing on the importance of standard setting body for shariah auditing in IFIs. Majority of the IFIs (92%) argued that a professional external body is needed to conduct shariah audit in IFIs to ensure stakeholders interest. According to (Ibrahim S. H., 2009) cited in (Onagun & Mikail, 9 February, 2013), Shariah auditing can be defined, “ *as a systematic process of obtaining sufficient and appropriate evidence to form an opinion as to whether the subject matter corresponds with the criteria / requirements of shariah rules, which is*

*broadly accepted and report to stakeholders thereon*”. The conventional auditor uses a phrase titled “True and Fair View” at the time of expressing audit opinion. However, in case of auditing in Islamic Financial Institutions it is not used properly. (Ibrahim S. H.) Cited in (Onagun & Mikail, 9 February, 2013).

Shariah audit of the financial transactions ensures the accuracy of the transactions and compliance to shariah regulations. Existing international shariah standards can serve as guidelines. Shariah audit should scrutinize the policies and procedures of the transactions, contracts, operation procedures etc. of the banks. Shariah audit should also examine the human resource structure of the bank to see that the bank is capable of ensuring shariah compliance. This includes the scrutiny of qualified workforce having sufficient knowledge on shariah. In order to carryout shariah audit the shariah auditors must have clear understanding of the business of the bank, terms and conditions of contracts following shariah principles. The shariah auditor should also have the proper skills for auditing and knowledge of the techniques used for auditing, to ensure shariah compliance.

There is no proper shariah auditing system available now. For launching products and services Islamic banks in Bangladesh need to have the approval of the shariah committee. However, to ensure shariah compliance, there is no systematic and compliance shariah auditing. As a result, Islamic banks fail to plan, execute and report according to shariah audit.

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## Chapter-8: Methodology

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In this chapter, the way the research was conducted is described. For collecting primary data a questionnaire consisting of thirty-five questions was distributed among Accounting Academicians, Audit Practitioners and Shari'ah Scholars in Bangladesh. Convenience sampling or purposive sampling was used to choose the sample. In the questionnaire, there were both 'open-ended' and 'close-ended' type questions.

The respondent's background was:

1. Muslim accounting academicians: Muslim lecturers teaching at the Accounting Program in public universities in Bangladesh.
2. Muslim audit practitioners: Muslim audit practitioners in Bangladesh.
3. Shari'ah scholars: Members of the Shari'ah Committee of the Islamic banks in Bangladesh.

There were six sections in the questionnaire named as:

1. Demographic data of the respondents
2. Awareness of the term "Shari'ah Audit"
3. Qualifications and appointers of shariah auditors
4. Business area audited by shari'ah auditor
5. Need of shariah audit side-by-side shariah review
6. The role of Islamic banks in promoting the shariah audit.

The first section was designed to collect demographic data among the respondents. The second section was designed in a fashion that the respondents would inform about the knowledge's and awareness of shariah audit. This section was also designed to get the respondents idea about establishing shariah auditing as separate and individual discipline. The third section was designed to get opinions of the

respondents about the qualifications of shariah auditors and their appointers. The fourth section was described to get the opinion of the respondents about the nature and scope of the shariah auditing. The fifth section was designed to get opinions of the respondents about implementing shariah audit side-by-side shariah review. The last section was designed to know about the roles of Islamic banks in Bangladesh in creating awareness about shariah auditing and compliance among general people. For the purpose of my research, secondary data was assembled from different databases, the Internet and literature. The objective of my research was to investigate and interpretation of the term shariah auditing by the respondents, issues relating to it and its future implications. A combination of quantitative and qualitative method was used to get the result. A frequency distribution method was used to examine the pattern of the respondents (positivistic approach) and Hermeneutic approach was used to interpret the views of the respondents.

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## **8.1 Scientific Approach**

Scientific researches are of two types in nature, the positivistic and hermeneutic. Logic and quantitative measurements express positivistic approach (Erikson & Wiedersheim-Paul, 2001) and holistic way of analysis and discussion is the expression of hermeneutic approach. In social science research scientific methods are not suitable (Arbon & Bjerke, 1994). The hermeneutic method achieves knowledge through interpretation and dialogue. The understanding is linked to the pre-understanding of the subject. Before conducting a research a researcher has some background knowledge about the subject. During the research the researcher gets in-depth knowledge about the topic through dialogue with the respondents, people having more knowledge about the subject and literature on the subject. The researcher

interprets the knowledge gain through these processes. On the way new issues come and are answered through new dialogues with research instruments (Erikson & Wiedersheim-Paul, 2001). The purpose of the research is to investigate the interpretations of “Shari’ah Auditing” in Islamic Banks and issues relating to it by accounting academicians, audit practitioners and Shari’ah scholars in Bangladesh. To get the real picture about the theory and practice of shariah auditing and compliance positivistic approach is appropriate and for interpreting the views of the respondents a hermeneutic twisting has been an important tool in the process. While conducting the research, I carried out open-ended interviews with the respondents, which threw light on some important aspects of implementing shariah audit in Bangladeshi Islamic banks. Theories of transaction costs, monitoring costs, agency-problem and residual claimants along with the interviews with the respondents give some clear indications why there should be a shariah audit in Bangladeshi Islamic banks.

## **8.2 Research Approach**

The purpose of the research is to investigate the interpretations of “Shari’ah Auditing” in Islamic Banks and issues relating to it by accounting academicians, audit practitioners and Shari’ah scholars in Bangladesh. The purpose of the study does not allow the research to be either positivistic or hermeneutic in nature. A mixed approach is best suited to the purpose. To get the real picture about the shariah auditing and compliance a scientific and quantitative approach was used. And for interpreting the views of the respondents a hermeneutic approach was taken.

### **8.2.1 Data Collection**

A total of thirty-five questions were distributed which was filled up by Accounting Academicians in public university, Conventional Audit practitioner and Shariah Scholars in Bangladesh. Information for the filled in questions was used for analysis.

### **8.2.2 Data Analysis**

The study used the frequency distribution to examine the pattern of responses to each of the variables under investigation. Then the categories will be listed and the number of observation will be counted (Ghauri & Gronhaug, 2010) cited in (Yaacob & Donglah, 2012).

### **8.3 Qualitative or Quantitative method**

A research can be conducted following either a quantitative or a qualitative method (Andersen, 1998). The quantitative method follows mathematical and statistical guidelines. Quantitative method is formalized and structured (Holme & Solvang, 1997). On the other hand, the qualitative method tries to have a deeper understanding. In qualitative studies extensive information is gathered from different sources and qualitative studies are flexible and they try to understand and analyze patterns (Troost, 1997). For the present purpose a combination of both qualitative and quantitative method was used for understanding the real picture about the theory and practice of “Shari’ah Auditing” in Islamic Banks of Bangladesh and issues relating to it.

### **8.4 Primary Data**

Both primary and secondary data were used in this research. For collecting primary data a survey questionnaire (**see Appendix-1**) consisting 35 questions was designed and distributed among the respondents (Accounting Academicians, Audit Practitioners and Shari’ah Scholars in Bangladesh). Using survey questionnaire to get opinions, interpretations and attitudes is an effective way of conducting a research (Ghauri & Gronhaug, 2010). It also helped analyzing the information collected from the respondents and disseminating information.

In the questionnaire there were both ‘Open-ended’ and ‘close-ended’ questions. For the ‘close-ended’ questions, the awareness was given in the form of Likert scales of five. The ranges are:

1. Strongly Agree
2. Agree
3. Neutral
4. Disagree and
5. Strongly disagree.

To know the things detail interview session were arranged with the respondents. All these serve as primary data.

#### **8.4.1 Interviews**

To conduct this research, both primary and secondary data were used. For collecting primary data a survey questionnaire was designed and distributed among the respondents. In the questionnaire there were both ‘Open-ended’ and ‘close-ended’ questions. Interviews with the Accounting Academicians, Audit Practitioners and Shari’ah Scholars in Bangladesh were arranged to get in-depth knowledge about theory and practice of “Shari’ah Auditing” in Islamic Banks of Bangladesh and issues relating to it. These interviews help a lot in getting a holistic view.

The ‘Accounting Academicians’ (university lecturers) were interviewed because they have solid theoretical knowledge about the practice of shariah auditing in Bangladesh. ‘Conventional Audit Practitioners’ were interviewed because they know best what is happening in the Islamic banks of Bangladesh as presently they are auditing these



banks. The ‘Shariah Scholars’ were also interviewed because they have the knowledge of Islamic Shariah compliance more than other respondents.

Personal interviews have some specific advantages. The interviewer can ask follow-up questions and get information, which he/she thinks important. The interviewer can listen to the full answer of the interviewee, take notes and ask questions whether necessary. Sometimes the questioner can explain the question so that the interviewee can understand the question better.

There are some disadvantages of personal interviews as well. Sometimes it may become very difficult to arrange an interview session with a respondent. The interviewer may sometimes influence the interviewee’s answer (Erikson & Wiedersheim-Paul, 2001). To avoid this, no leading questions (giving hint to the interviewee about what the answer could be) were asked.

## **8.5 Secondary Data**

When a researcher takes information from some body else’s analysis it becomes secondary data. It is cheaper and in most of the cases easier to achieve than primary data (Andersen, 1998). As secondary data different sources were used in this research. Books, research articles, newspapers, databases, annual report of the banks, Internet etc. were used.

There are a few disadvantages of using secondary data. There is a chance of using irrelevant information. The information taken from secondary sources are almost always adjusted to the research because the person who collected the data did not want to investigate the issue being investigated by the researcher (Andersen, 1998).

## **8.6 Research Justification**

Evaluating and questioning the sources of the research is an important tool of the justification of the research. Through the justification of research validity, reliability and relevance of the sources are measured. While conductive qualitative research it is easier to measure the validity and the reliability of the research than conducting qualitative research. The validity and the reliability of a research basically depend on the representativeness of the data and statistical analysis (Holme & Solvang, 1997). The higher the validity and reliability of a research the better the quality of the research in nature.

### **8.6.1 Validity**

The research is valid if it addresses the issues it was supposed to address (Smith, 2000). If the data of the research are incorrect and the conclusions are drawn from this incorrect data, the validity of the research is hampered. To ensure and improve the validity of the research a few questions have to be addressed. Were the most relevant respondents selected for questioner survey and interviews? Were the relevant questions asked in the questionnaire and in the interviews? Were all the relevant issues taken care of properly? These questions and issues were considered while choosing the respondents and formulating questions. The respondents were selected depending on the criteria that they were knowledgeable on the topic of the research. However, interviews may become subjective sometimes. The perception of the interviewer may be wrong or the interviewer may influence the interviewee's answers (Holme & Solvang, 1997). While conducting the interviews these issues were considered carefully.

### **8.6.2 Reliability**

The reliability of a research looks into the possibility of getting the conclusion drawn from the research. It measures the trustworthiness of the research by analyzing the measurement standards of the research (Andersen, 1998). The research is reliable if the result of the research agrees with the result drawn by some other researchers (Erikson & Wiedersheim-Paul, 2001). In the case of this research if any other researchers investigated the same issues, they would have got the same results. To avoid the human error of directing the interviews to a certain direction, a predesigned set of questions were used in the interviews. It strengthened the reliability of the research.

### **8.6.3 Relevance**

If the research is conducted for serving the people and not only serving the purpose of the researcher, then the research is relevant (Eriksson & Wiedersheim-Paul 2001). The present research was designed to serve the benefit of the people of Bangladesh. It aimed at setting standards for proper shariah audit of the Islamic banks in Bangladesh so that the Islamic banks operate following Islamic shariah strictly as the meaning of Shariah is a heavenly guidance given by the Holy Qur'an and the Sunnah of Prophet Muhammad (PBUH) and characterizes all aspects of the Islamic faith, including beliefs, practices, rules and principles.

### **8.6.4 Questioning the Sources**

Any research depends on the sources of data. So, the sources have to be precise. A researcher needs to pick the exact, relevant, valid and reliable sources (Erikson & Wiedersheim-Paul, 2001). The sources can be questioned in four steps: (1) Observation (2) Origin (3) Interpretation and (4) Usefulness (Holme & Solvang,

1997). While selecting the respondents the above mentioned issues were considered. It was ensured that the respondents have proper knowledge about the theory and practice of shariah auditing in Bangladeshi Islamic banks.

The secondary sources were collected thoroughly so that information could be gathered from all aspects of shariah auditing in Bangladeshi banks. The articles used as secondary sources were published in peer-reviewed journals. Knowledgeable researchers scrutinized these articles. So, the secondary sources used in this article were reliable. Before filling up the questionnaire form and before interviews the respondents were informed about the topic of this research. This was done to avoid any misinterpretation of the topic. While using the secondary sources the information were read and re-read a few times to avoid the problem of misinterpretation.

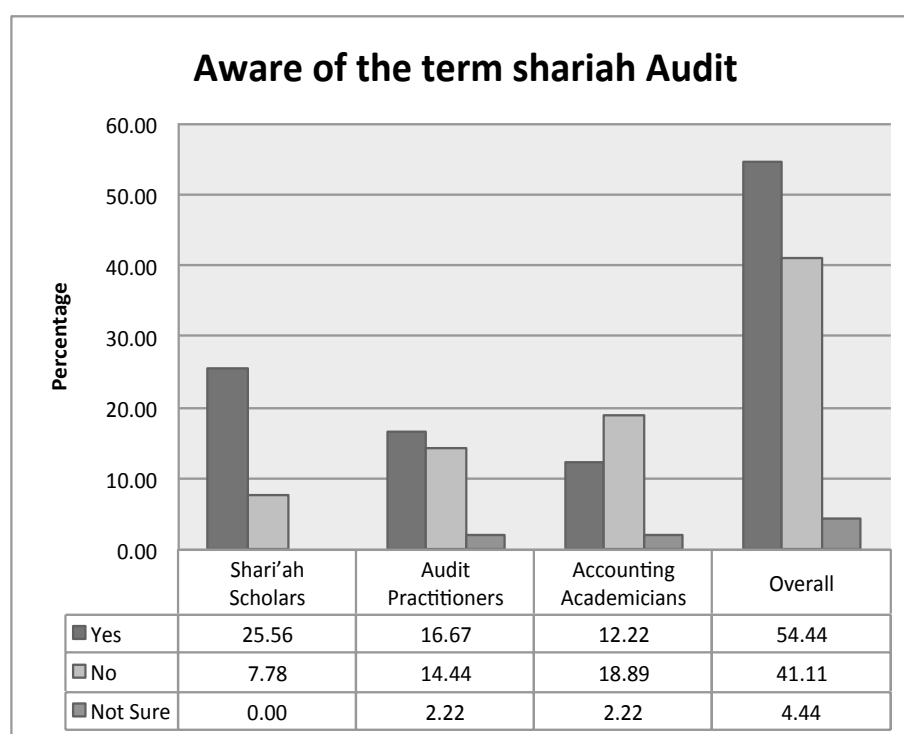
From the secondary sources useful information were utilized and irrelevant information were excluded. While conducting the interviews it was also considered whether we were getting useful information.

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## Chapter-9: Results

**Table 9.1:** Awareness of the term ‘Shariah Audit’

	Shari’ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	23	25.56	15	16.67	11	12.22	49	54.44
No	7	7.78	13	14.44	17	18.89	37	41.11
Not Sure	0	0.00	2	2.22	2	2.22	4	4.44
Total	30	33.33	30	33.33	30	33.33	90	100.00



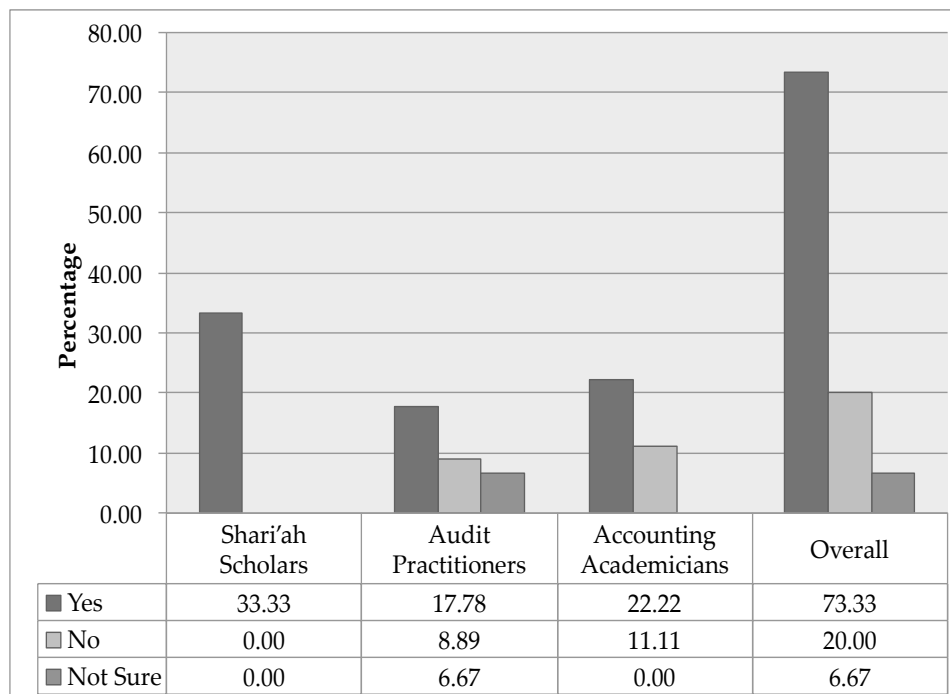
**Figure 9-1:** Awareness of the term ‘Shariah Audit’

There is a clear difference of opinion among the respondents about this particular issue. This graph shows that 54.44% of the respondents are aware of Shariah audit and 41.11% of them are unaware. While Shariah Scholars (25.56%) are well aware of Shariah audit, the Accounting Academicians (18.89%) and conventional audit practitioners (14.44%) are more unaware of Shariah audit than other respondents.

This graph also shows that total 4.44% of the respondents are not sure about the term shariah auditing.

**Table 9.2:** Difference between Shariah audit and Conventional audit

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	30	33.33	16	17.78	20	22.22	66	73.33
No	0	0.00	8	8.89	10	11.11	18	20.00
Not Sure	0	0.00	6	6.67	0	0.00	6	6.67
Total	30	33.33	30	33.33	30	33.33	90	100.00



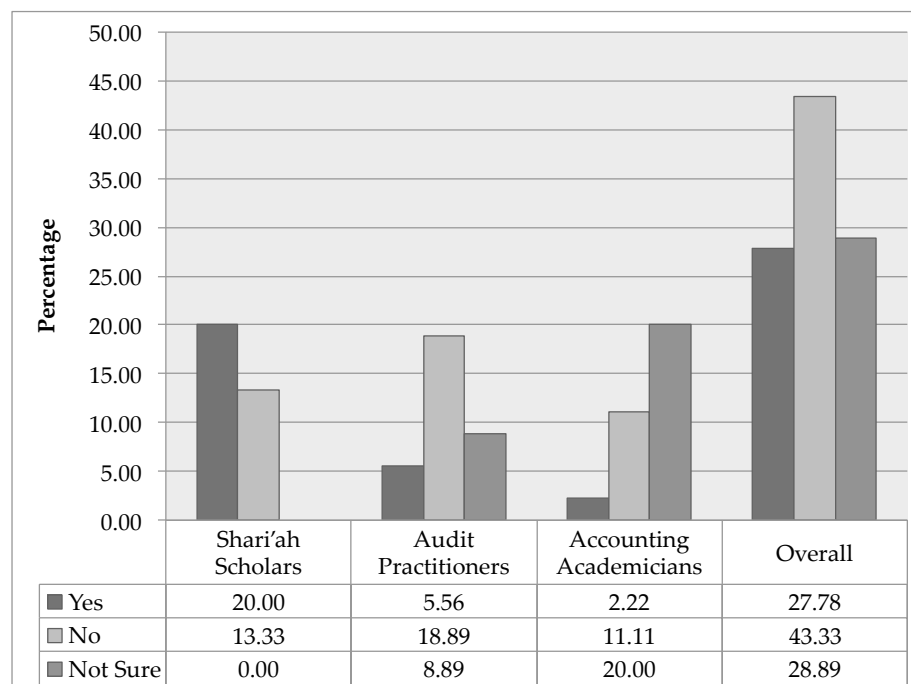
**Figure9-2: Difference between Shariah audit and Conventional audit**

This graph shows that the majority of the respondents (73.33 %) know that Shariah audit are different from conventional audit. All the groups of respondents are well aware of the difference between Shariah audit and conventional audit. However, there is a high percentage (11.11%) among the Accounting Academicians and conventional audit practitioners (8.89%) who do not know the difference between the two. This graph also shows that, a total 6.67% of the respondents are not sure whether there is

any difference between shariah audit and conventional audit or not. This graph also shows that, while shariah scholars are more aware about the difference between shariah audit and conventional audit, audit practitioners and accounting academicians are less unaware.

**Table 9-3:** Shariah audit framework and Conventional audit framework

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	18	20.00	5	5.56	2	2.22	25	27.78
No	12	13.33	17	18.89	10	11.11	39	43.33
Not Sure	0	0.00	8	8.89	18	20.00	26	28.89
Total	30	33.33	30	33.33	30	33.33	90	100.00



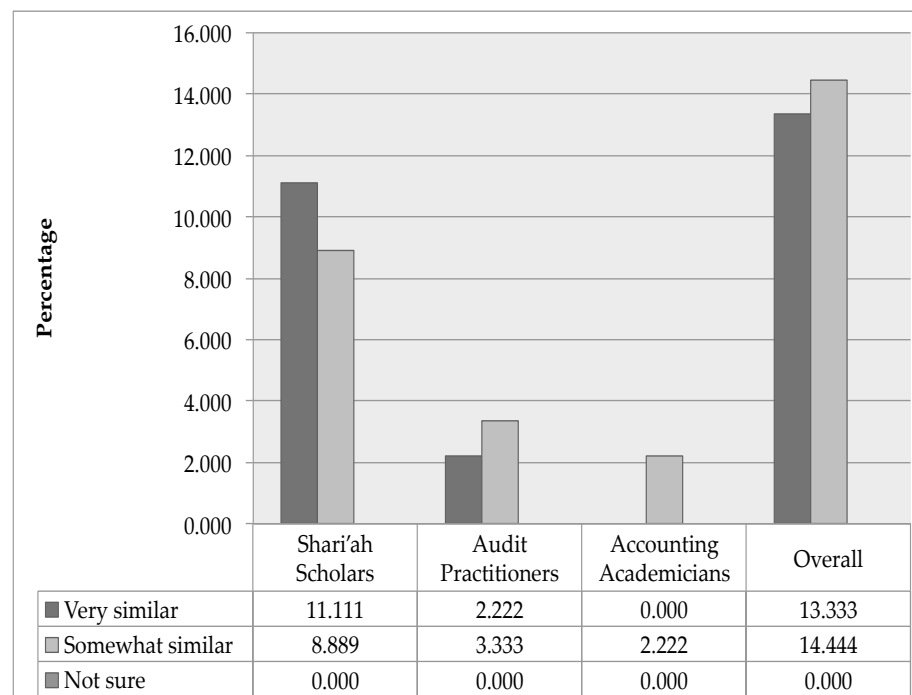
**Figure 9-3:** Shariah audit framework and Conventional audit framework

This graph shows that about half of the respondents (43.33%) consider that Shariah audit framework and conventional audit framework are similar. However, 27.78% believe that these two frameworks are different while more than one-fourth of the

respondents (28.89%) do not know whether these two frameworks are similar or not. This graph also shows that, audit practitioners and accounting academicians about the similarities between shariah audit and conventional audit.

**Table 9-4:** Similarity between frameworks of Shariah audit and Conventional audit

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Very similar	10	11.11	2	2.22	0	0.00	12	13.33
Somewhat similar	8	8.89	3	3.33	2	2.22	13	14.44
Not sure	0	0.00	0	0.00	0	0.00	0	0.00
Total	18	20.00	5	5.56	2	2.22	25	27.78



**Figure9-4: Similarity between frameworks of Shariah audit and Conventional audit**

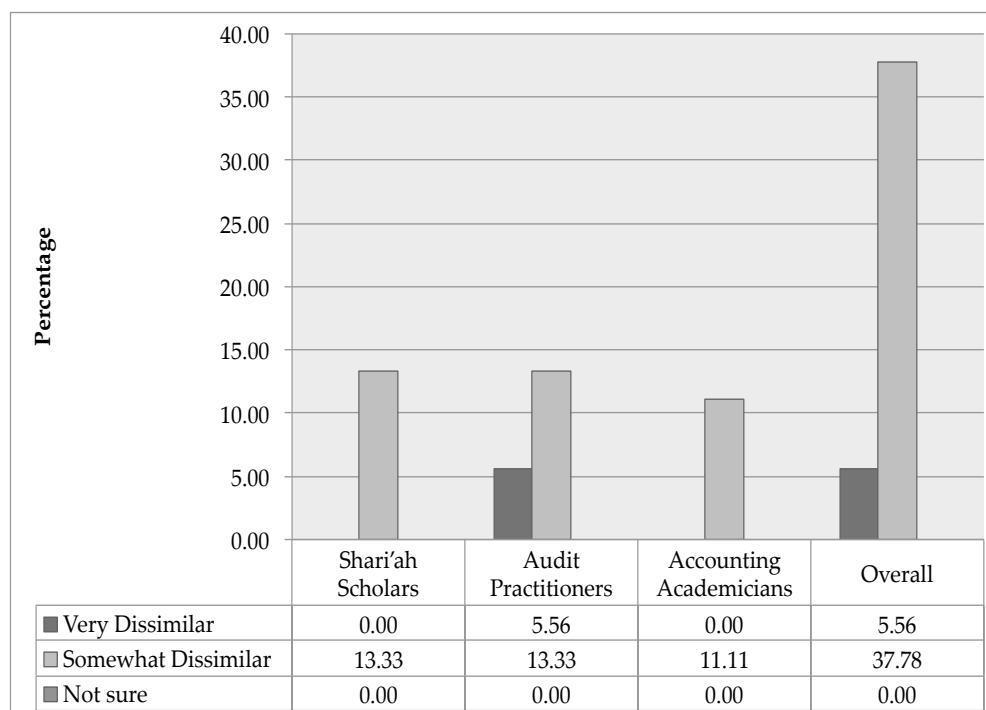
This graph shows that 27.78% of the total respondents think that Shariah audit framework is similar to that of conventional audit framework. However, 13.33% among this 27.78% think that these two frameworks are very similar and 14.44% believe that they are somewhat similar. This graph also shows that; there were no



respondents who do not have any confusion regarding the similarities between shariah audit and conventional audit.

**Table 9-5:** Dissimilarity between framework of Shariah audit and conventional

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Very Dissimilar	0	0.00	5	5.56	0	0.00	5	5.56
Somewhat Dissimilar	12	13.33	12	13.33	10	11.11	34	37.78
Not sure	0	0.00	0	0.00	0	0.00	0	0.00
Total	12	13.33	17	18.89	10	11.11	39	43.33



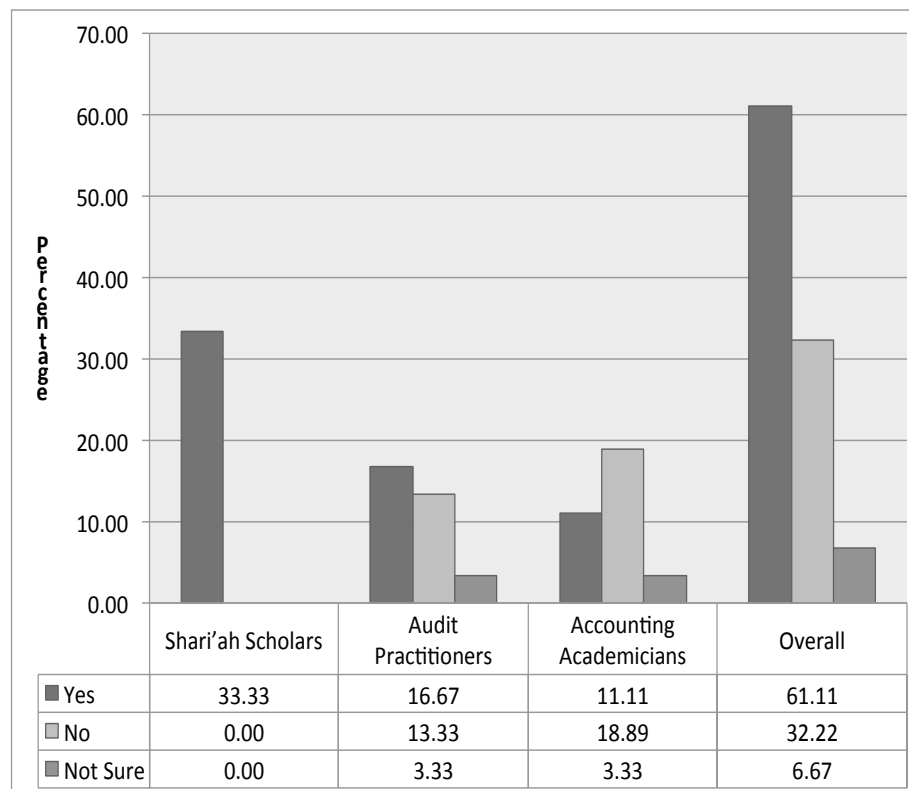
**Figure 9-5: Dissimilarity between framework of Shariah audit and conventional audit**

This graph shows that among 43.33% of the total respondents who think the frameworks of Shariah audit and conventional audit are different, 37.78% considered the frameworks as somewhat dissimilar and 5.56% think the frameworks to be very similar. Table 3, Table 4 and Table 5 show that a healthy amount of respondents

(28.89% most of them are accounting academicians and conventional audit practitioners) are not sure about the difference between the Shariah audit framework and conventional audit framework.

**Table 9-6:** Basic knowledge and understanding of Shariah audit

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	30	33.33	15	16.67	10	11.11	55	61.11
No	0	0.00	12	13.33	17	18.89	29	32.22
Not Sure	0	0.00	3	3.33	3	3.33	6	6.67
Total	30	33.33	30	33.33	30	33.33	90	100



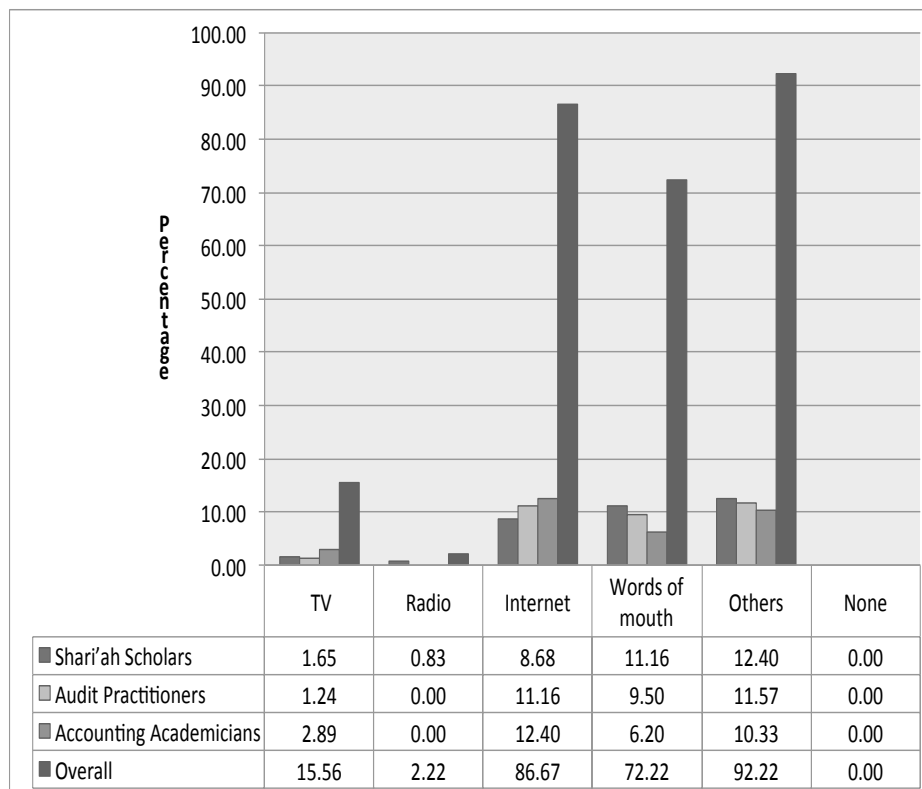
**Figure 9-6:** Basic knowledge and understanding of Shariah audit

This graph clarifies that most of the respondents (61.11%) have basic knowledge and understanding of Shariah audit. However, about one-third (32.22%) of the respondents

(most of them are conventional audit practitioners and accounting academicians) do not have the basic knowledge of understanding Shariah audit. However, a total of 6.67% of the respondents are not sure whether they have the basic knowledge on shariah auditing or not.

**Table 9-7: Shariah audit sources (Multiple answers)**

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
TV	4	1.65	3	1.24	7	2.89	14	15.56
Radio	2	0.83	0	0.00	0	0.00	2	2.22
Internet	21	8.68	27	11.16	30	12.40	78	86.67
Words of mouth	27	11.16	23	9.50	15	6.20	65	72.22
Others	30	12.40	28	11.57	25	10.33	83	92.22
None	0	0.00	0	0.00	0	0.00	0	0.00

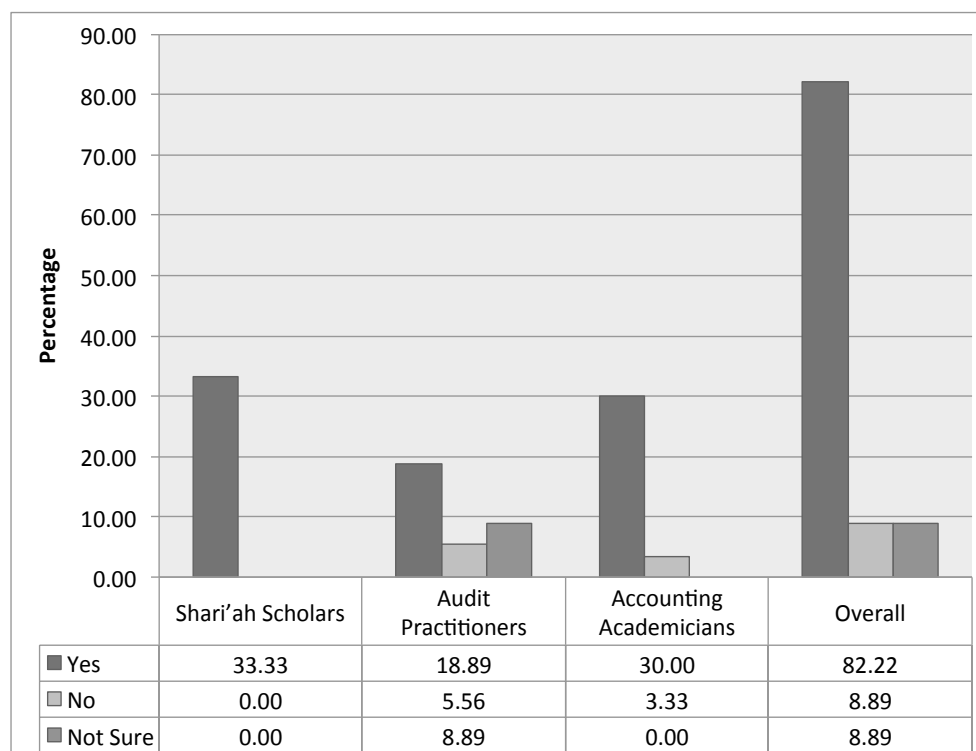


**Figure 9-7: Shariah audit sources (Multiple answers)**

In the questionnaire, the respondents were given an option to select multiple answer of that question. This graph shows that the 'Internet' is the most influential source of information from where respondents knew about the Shariah audit. However, many of the respondents have known about Shariah audit from the other people. While conducting the research, I carried out some open-ended interviews with the respondents, which threw light on other sources (Books, journals and some educational institution) from where the respondents have known about shariah audit.

**Table 9-8:** Shariah audit as a new discipline

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	30	33.33	17	18.89	27	30.00	74	82.22
No	0	0.00	5	5.56	3	3.33	8	8.89
Not Sure	0	0.00	8	8.89	0	0.00	8	8.89
Total	30	33.33	30	33.33	30	33.33	90	100.00

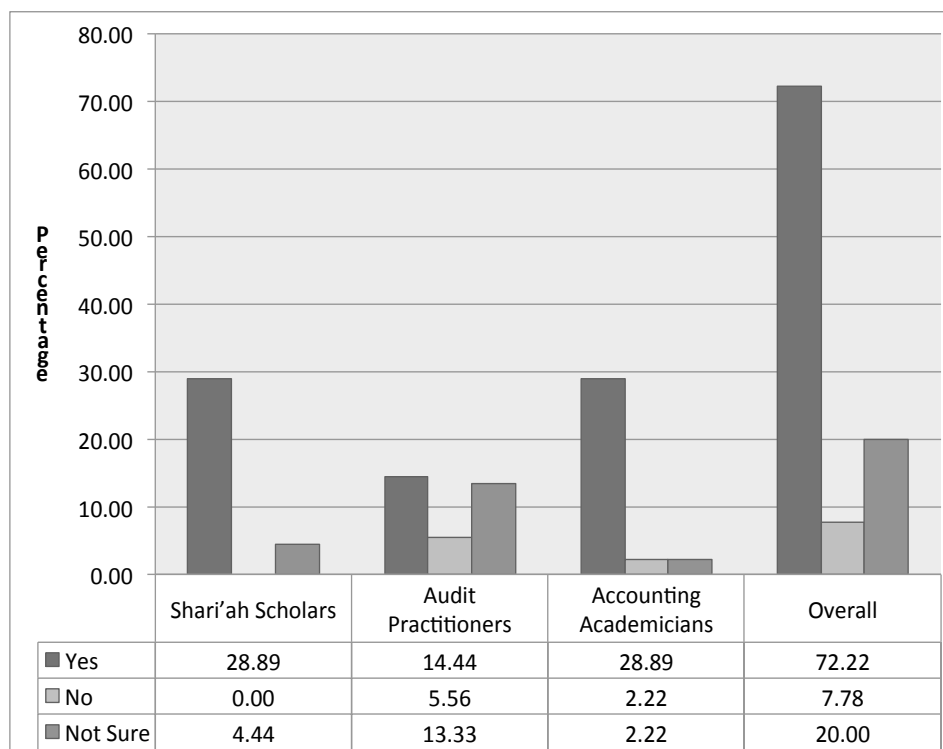


*Figure 9-8: Shariah audit as a new discipline*

There is a clear consistency of opinion among the respondents about this particular issue. It is quite significant that 82.22% of the respondents think that in order to maintain and ensure shariah compliance, Shariah audit should be a new discipline; it should be studied as a separate and individual branch of knowledge. However, 8.89% of the respondents do not think that shariah audit should be a separate discipline. This graph also shows that 8.89% of the respondents do not whether shariah auditing should be a separate and individual discipline or not.

**Table 9-9: Definition of Shariah Review by AAOIFI**

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	26	28.89	13	14.44	26	28.89	65	72.22
No	0	0.00	5	5.56	2	2.22	7	7.78
Not Sure	4	4.44	12	13.33	2	2.22	18	20.00
Total	30	33.33	30	33.33	30	33.33	90	100.00

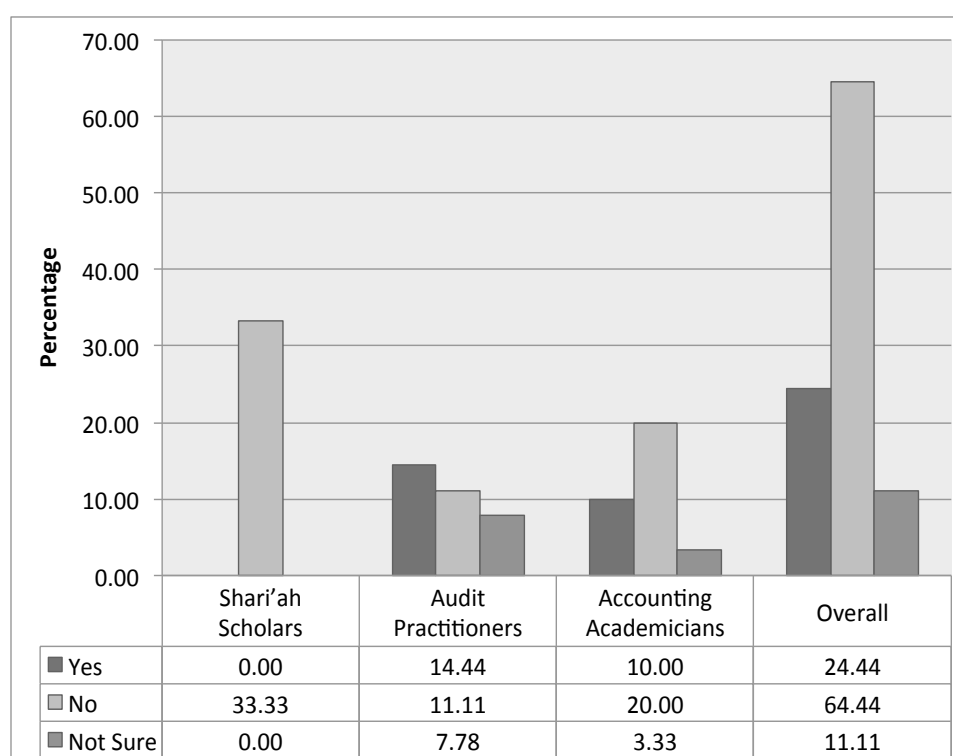


**Figure 9-9: Definition of Shariah Review by AAOIFI**

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) uses the term shariah review instead of the term shariah audit. According to their definition “Shari’ah Review” is “An examination of the extent of IFIs compliance, in all its activities with the shariah”. This graph shows that, while most of the respondents (72.22%) agree with the definition, 20.00% of the respondents (most of them conventional audit practitioners) are not sure whether the definition is appropriate or not. However, a total of 7.78% of the respondents opined that the definition given by AAOIFI is not appropriate.

**Table 9-10:** External auditors carrying the Shariah audit

	Shari’ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	0	0.00	13	14.44	9	10.00	22	24.44
No	30	33.33	10	11.11	18	20.00	58	64.44
Not Sure	0	0.00	7	7.78	3	3.33	10	11.11
Total	30	33.33	30	33.33	30	33.33	90	100.00

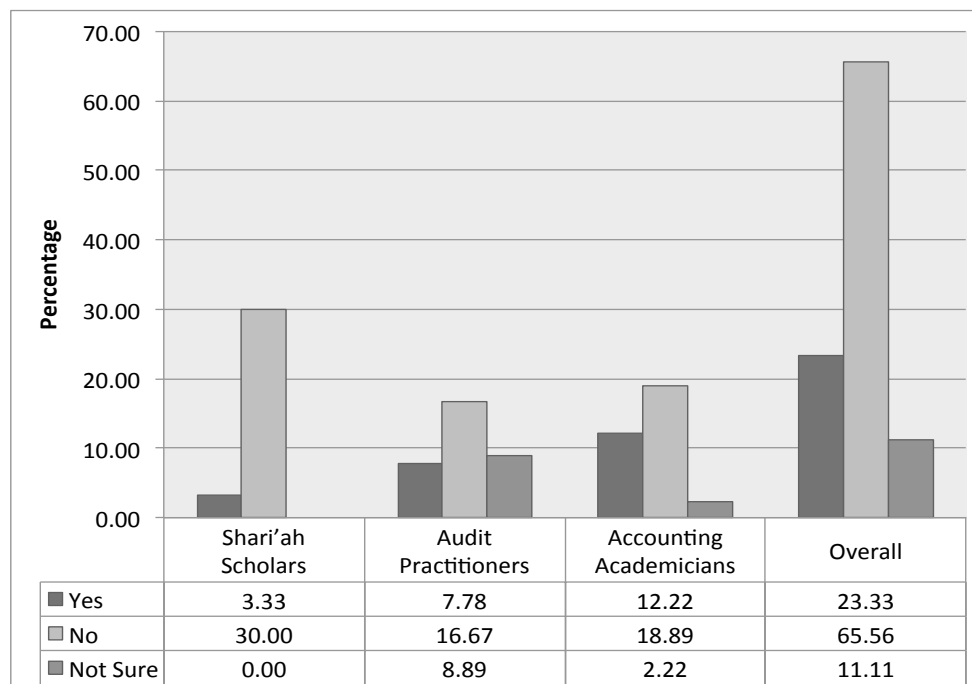


**Figure 9-10:** External auditors carrying the Shariah audit

About two-third of the respondents (64.44%) opined that external auditors should not carry out the shariah audit. However, one-fourth of the respondents (24.44%) who think external auditors should be the shariah auditors come primarily from audit practitioners (14.44%). This graph also shows that 11.11% of the respondents do not sure that whether an external (regular) conventional should audit the Islamic bank or not. While almost all the respondents of shariah scholars (33.33%) and majority of the respondents (20%) of the accounting academicians opined that an external traditional auditor should not be the auditor of Islamic bank, audit practitioners (14.44%) argued that an external conventional auditor might audit the Islamic bank.

**Table 9-11:** Islamic Scholars (Ulama) carrying the Shariah audit

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	3	3.33	7	7.78	11	12.22	21	23.33
No	27	30.00	15	16.67	17	18.89	59	65.56
Not Sure	0	0.00	8	8.89	2	2.22	10	11.11
Total	30	33.33	30	33.33	30	33.33	90	100.00

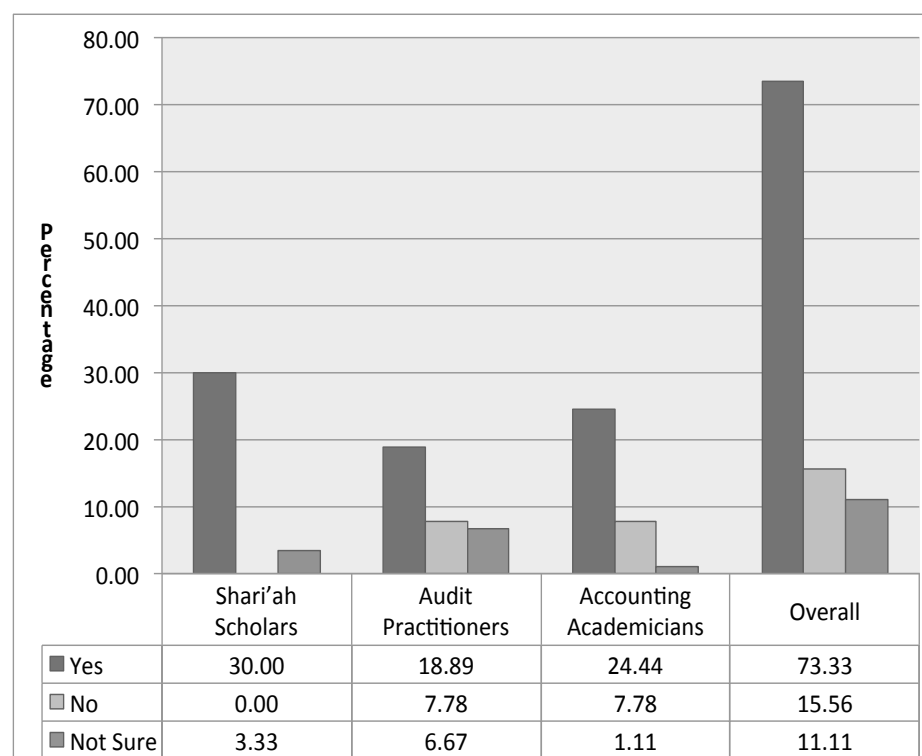


**Figure 9-11:** Islamic Scholars (Ulama) carrying the Shariah audit

This graph shows that about two-third of the respondents (65.56%) opined that Islamic Scholars should not carry out the shariah audit. However, one-fourth of the respondents (22.33%) who think Islamic Scholars should be the shariah auditors come primarily from accounting academicians (12.22%). Among them the respondents of shariah scholars (30%), accounting academicians (18.89%) and audit practitioners (16.67%) argued that shariah scholars (Ummah) should not carry out shariah audit in Islamic banks in Bangladesh. However, 11.11% of the respondents do not know whether the Islamic Ummah will carry out shariah audit or not.

**Table 9-12:** Internal auditors under the guidance of SSC carrying Shariah audit

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	27	30.00	17	18.89	22	24.44	66	73.33
No	0	0.00	7	7.78	7	7.78	14	15.56
Not Sure	3	3.33	6	6.67	1	1.11	10	11.11
Total	30	33.33	30	33.33	30	33.33	90	100.00



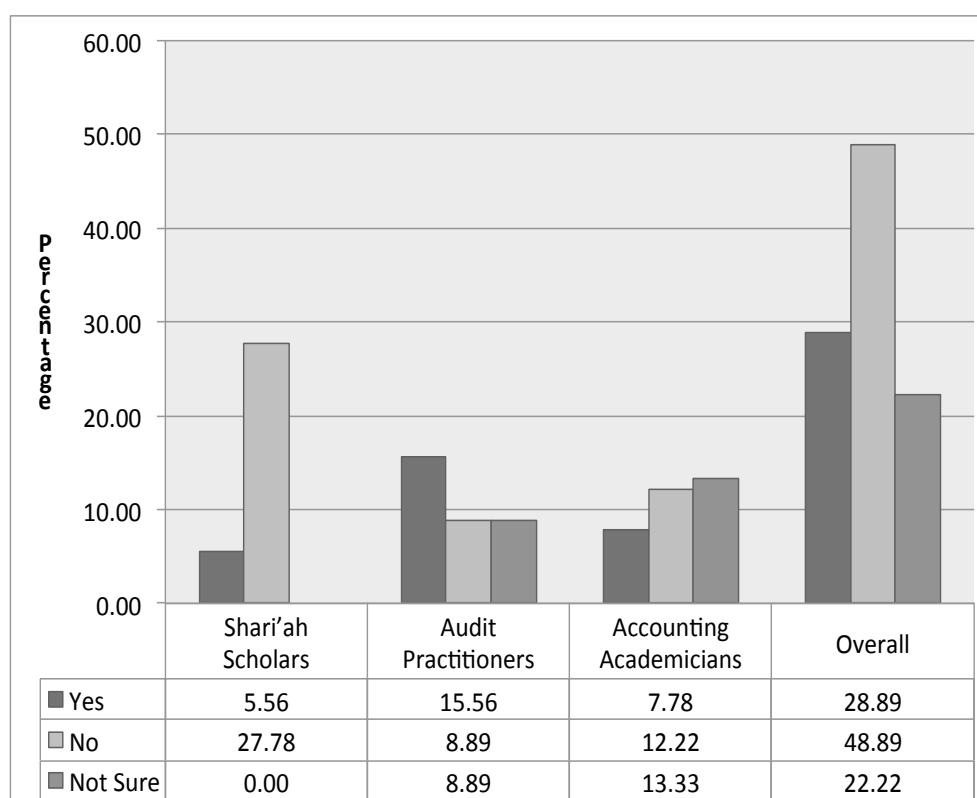
**Figure 9-12:** Internal auditors under the guidance of SSC carrying Shariah audit



About three-fourth of the respondents (73.33%) think that internal auditors under the guidance of Shari'ah Supervisory Committee (SSC) should carry out Shariah audit in Islamic Banks in Bangladesh. This graph also shows that 15.56% of the respondents opined that internal auditor under the guidance of shariah supervisory committee should not carry out shariah audit. However, 11.11% of the respondents do not know whether an that internal auditor under the guidance of shariah supervisory committee should audit Islamic banks or not.

**Table 9-13:** Shari'ah Supervisory Committee (SSC) carry out Shariah audit

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	5	5.56	14	15.56	7	7.78	26	28.89
No	25	27.78	8	8.89	11	12.22	44	48.89
Not Sure	0	0.00	8	8.89	12	13.33	20	22.22
Total	30	33.33	30	33.33	30	33.33	90	100.00

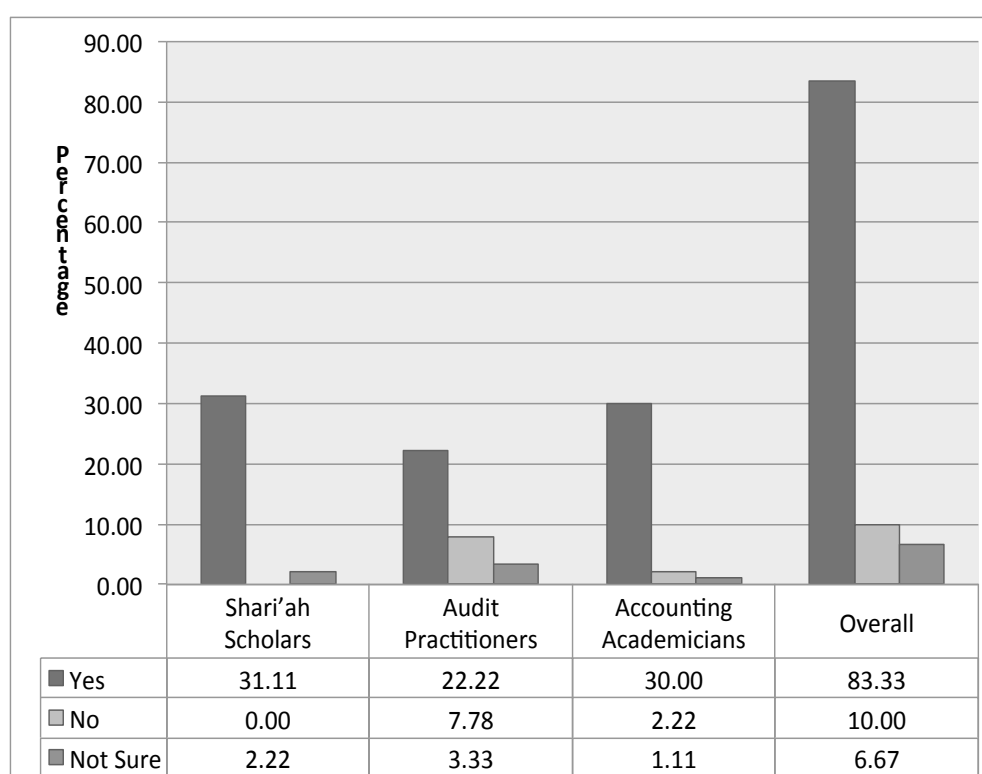


**Figure 9-13:** Shari'ah Supervisory Committee (SSC) carry out Shariah audit

There is a clear difference of opinion among the respondents about this particular issue. About half of the respondents (48.89%) think that Shariah Supervisory Committee (SSC) should not carry out shariah audit in Islamic banks. However, about one-third of the respondents (28.89%) think that SSC should carry out Shariah audit in Islamic banks. This graph also shows that one third of the respondents (22.22) do not know shariah scholar might be carried out shariah audit or not.

**Table 9-14: “Shari’ah Auditors” carrying shariah audit**

	Shari’ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	28	31.11	20	22.22	27	30.00	75	83.33
No	0	0.00	7	7.78	2	2.22	9	10.00
Not Sure	2	2.22	3	3.33	1	1.11	6	6.67
Total	30	33.33	30	33.33	30	33.33	90	100.00



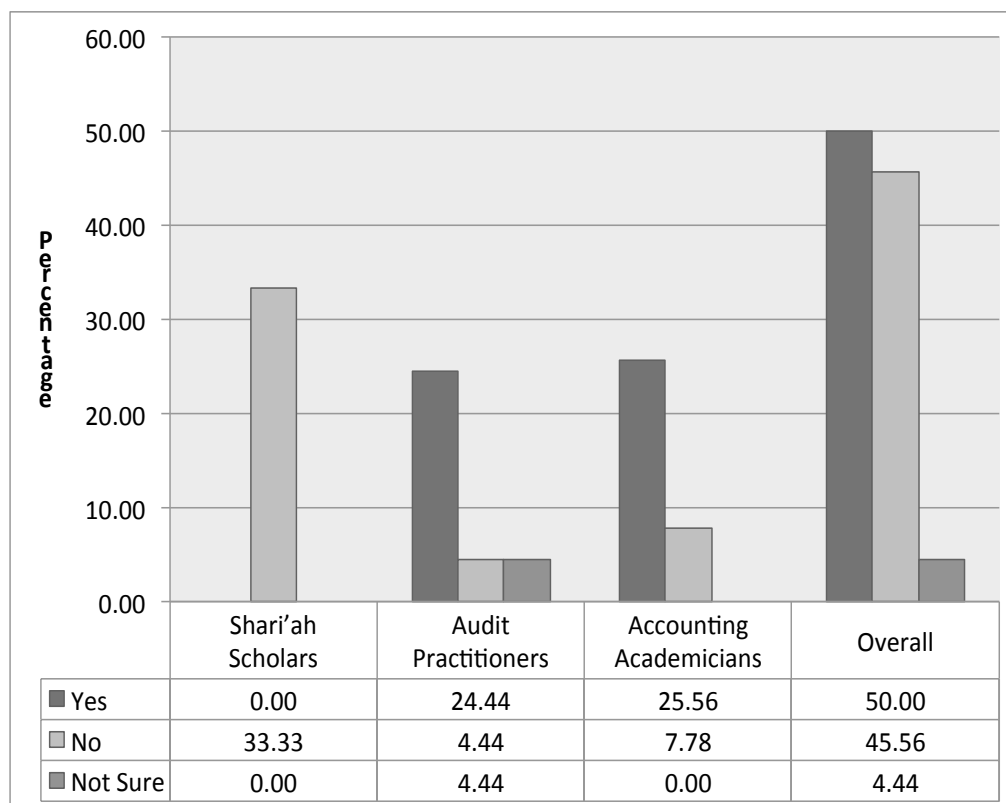
**Figure 9-14: “Shari’ah Auditors” carrying shariah audit**

There is a clear consistency of opinion among the respondents about this particular issue. This graph shows that most of the respondents (83.33%) think shariah auditors

who are professionals should carry out that shariah audit, trained and certified in shariah audit. However, 6.67% of the respondents are not sure.

**Table 9-15:** Appointers of Shariah auditors: Shareholders

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	0	0.00	22	24.44	23	25.56	45	50.00
No	30	33.33	4	4.44	7	7.78	41	45.56
Not Sure	0	0.00	4	4.44	0	0.00	4	4.44
Total	30	33.33	30	33.33	30	33.33	90	100.00



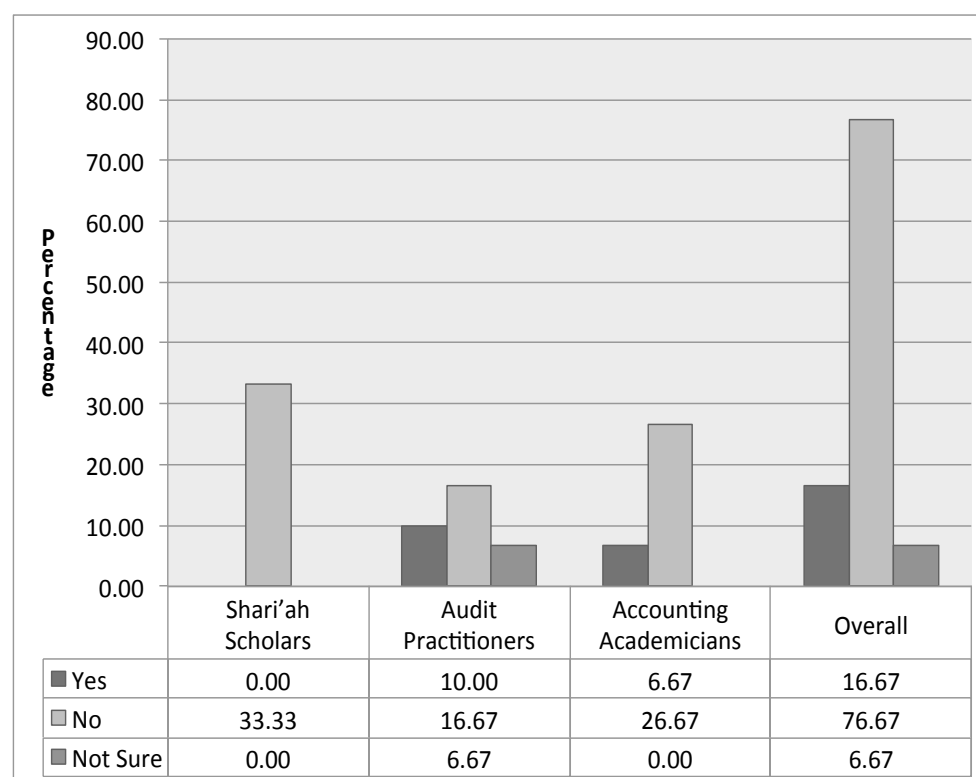
**Figure: 9-15:** Appointers of Shariah auditors: Shareholders

There is a clear difference of opinion among the respondents about this particular issue. Half of the respondents opined that shareholders of the respective islamic bank should appoint shariah audit through Annual General Meeting (AGM). However, 45.56% of the respondent's shareholders should not appoint shariah auditors. While all the shariah scholars (33.33%) of all the respondents think that shareholders should not appoint the shariah auditors, majority of audit practitioners (24.44%) and

accounting academicians (25.56%) think that shareholders should appoint the shariah auditors.

**Table 9-16:** Appointers of Shariah auditors: Bangladesh Bank (Central Bank)

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	0	0.00	9	10.00	6	6.67	15	16.67
No	30	33.33	15	16.67	24	26.67	69	76.67
Not Sure	0	0.00	6	6.67	0	0.00	6	6.67
Total	30	33.33	30	33.33	30	33.33	90	100.00



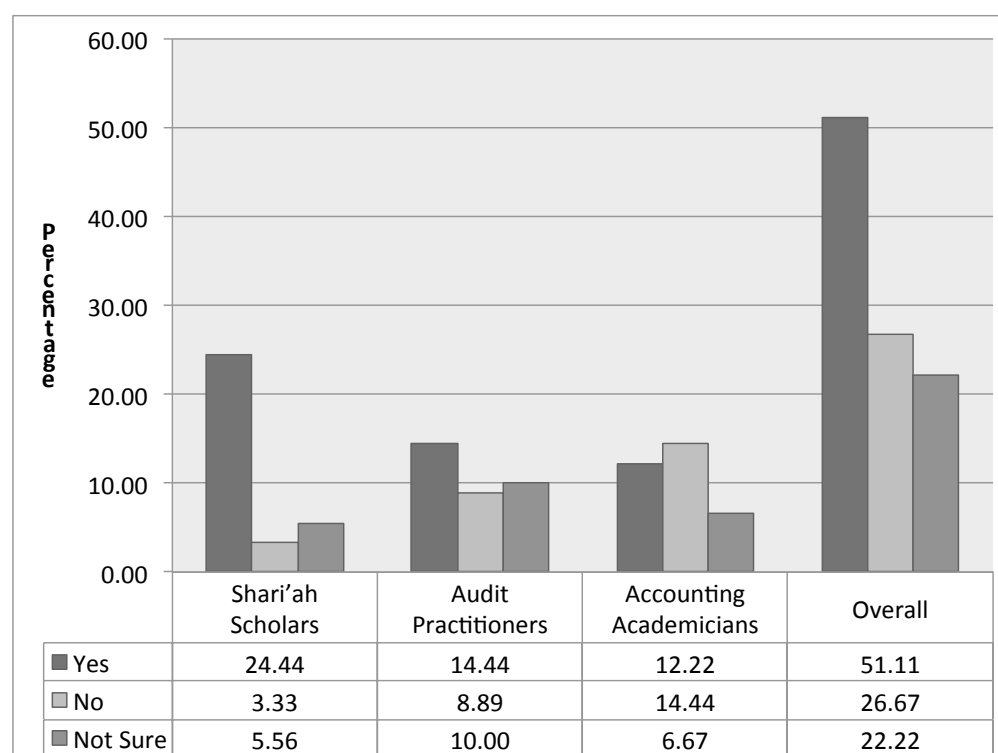
**Figure 9-16:** Appointers of Shariah auditors: Bangladesh Bank (Central Bank)

There is a clear consistency of opinion among the respondents about this particular issue of appointing shariah auditors in Islamic bank in Bangladesh. While 76.67% of the respondents do not except Bangladesh Bank (Central Bank) to be the appointing authority, 16.67% of respondents think that Bangladesh Bank should appoint shariah auditors. This graph shows that all the shariah scholars (33.33%) of all the respondents think that Bangladesh Bank (central bank of Bangladesh) should not appoint the

shariah auditors. At the same time majority of audit practitioners (16.67%) and accounting academicians (26.67%) also think that Bangladesh Bank should not appoint the shariah auditors. However, 6.67% of the respondents are not sure.

**Table 9-17:** Appointers of Shariah auditors: A new regulatory and supervisory body for observing “Shari’ah Audit”

	Shari’ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	22	24.44	13	14.44	11	12.22	46	51.11
No	3	3.33	8	8.89	13	14.44	24	26.67
Not Sure	5	5.56	9	10.00	6	6.67	20	22.22
Total	30	33.33	30	33.33	30	33.33	90	100.00



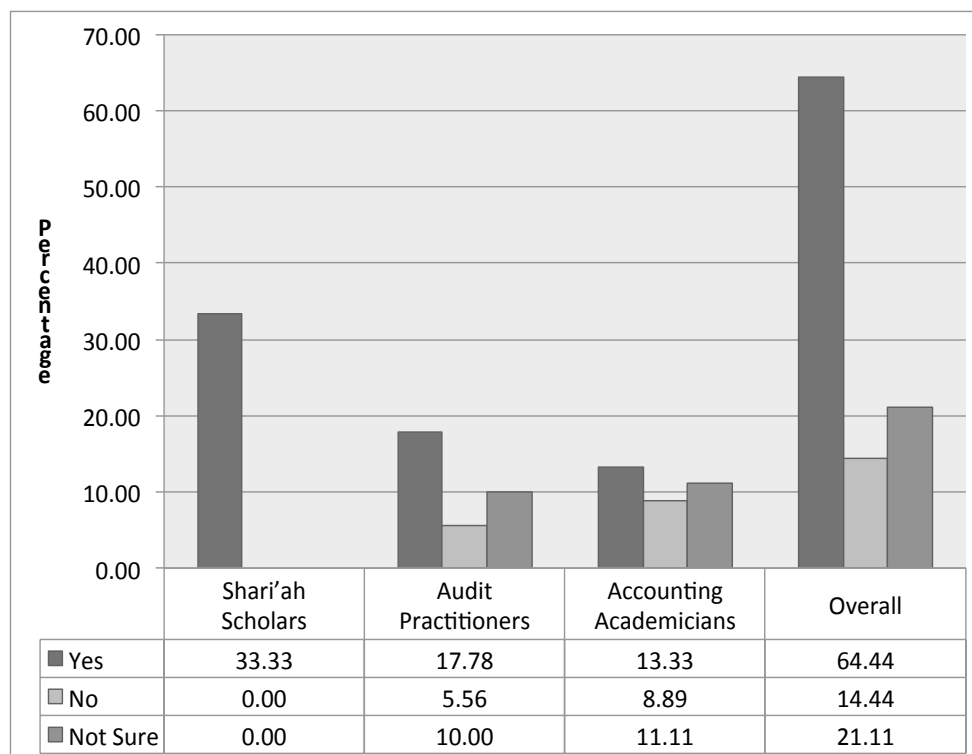
**Figure 9-17:** Appointers of Shariah auditors: A new regulatory and supervisory body for observing “Shari’ah Audit”

There is a clear difference of opinion among the respondents about this particular issue. This graph shows that, half (51.11%) of the respondents believe that there should be a new regulatory and supervising body that will appoint the shariah auditors. However, about one-fourth of the respondents (26.67%) respondents do not feel the

necessity of having a new regulatory and supervising body for recruiting shariah auditors. Majority of the respondents of shariah scholars (24.44%) opined that there should be a new regulatory and supervising body that will appoint the shariah auditors. However, a total of 22.22% of the respondents are not sure about this particular issue.

**Table 9-18:** Appointers of Shariah auditors: Shariah Supervisory Committee on behalf of the Board of Directors of institution.

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	30	33.33	16	17.78	12	13.33	58	64.44
No	0	0.00	5	5.56	8	8.89	13	14.44
Not Sure	0	0.00	9	10.00	10	11.11	19	21.11
Total	30	33.33	30	33.33	30	33.33	90	100.00



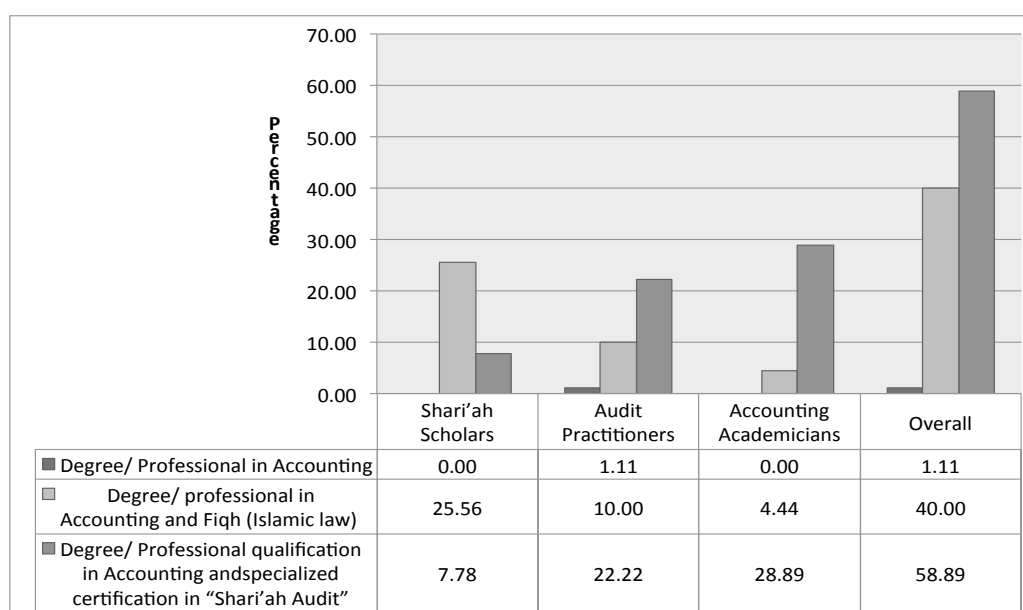
**Figure: 9-18:** Appointers of Shariah auditors: Shariah Supervisory Committee on behalf of the Board of Directors of institution

While 64.44% of respondents want Shariah Supervisory Committee on behalf of the Board of Directors to be the appointing authority of Shariah auditors, 21.11% respondents are not sure. This graph shows that all the respondents of shariah scholars

(33.33%) opined that Shariah Supervisory Committee (SSC) on behalf of the Board of Directors (BODs) of the respective Islamic bank should appoint shariah auditor. However, a total of 14.44% of the respondents of audit practitioners and accounting academicians do not think that Shariah Supervisory Committee on behalf of the Board of Directors to be the appointing authority of Shariah auditors.

**Table 9-19:** Required (Minimum) qualification of the “Shari’ah Auditor”

	Shari’ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Degree/ Professional in Accounting	0	0.00	1	1.11	0	0.00	1	1.11
Degree/ professional in Accounting and Fiqh (Islamic law)	23	25.56	9	10.00	4	4.44	36	40.00
Degree/ Professional qualification in Accounting and specialized certification in “Shari’ah Audit”	7	7.78	20	22.22	26	28.89	53	58.89
Total	30	33.33	30	33.33	30	33.33	90	100.00



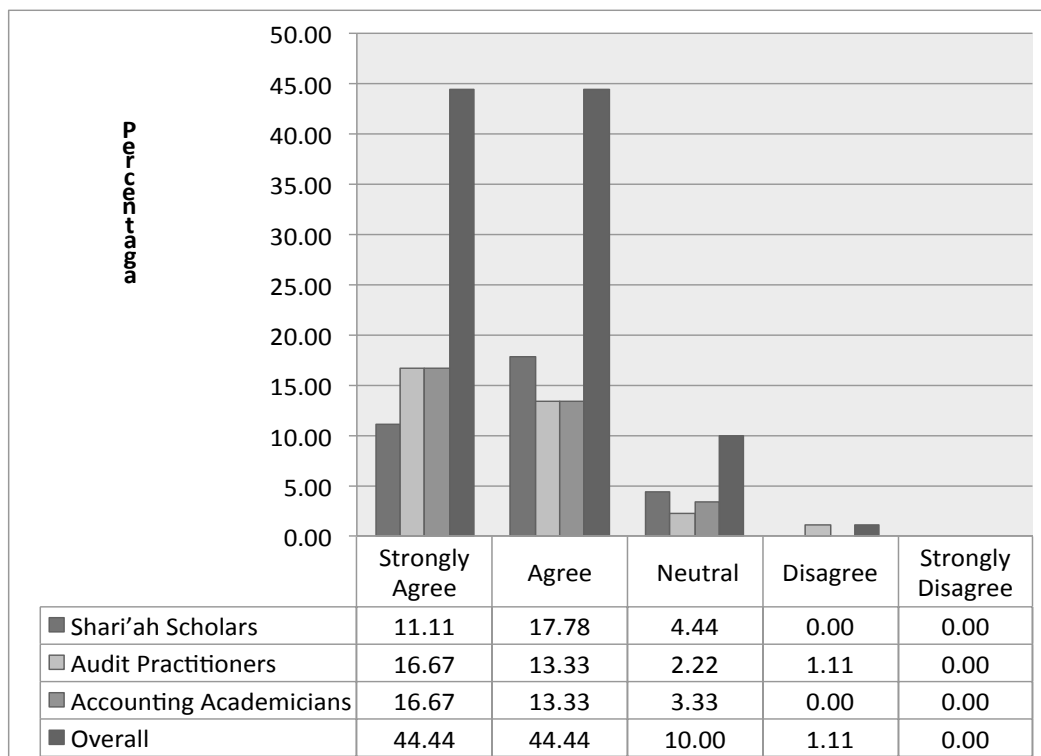
**Figure:9-19:** Required (Minimum) qualification of the “Shari’ah Auditor”

There is a clear difference of opinion among the respondents about this particular issue. While 58.89% respondents think Degree/ Professional qualification in Accounting and specialized certification in Shari’ah Audit should be the minimum

qualification to be a shariah auditor, 40.00% think that the minimum requirement should be Degree/ professional in Accounting and Fiqh (Islamic law). Only 1% of the respondents opined that Degree/ Professional qualification in Accounting should be the minimum qualification to be a shariah auditor.

**Table 9-20: Specialized shariah certification**

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Strongly Agree	10	11.11	15	16.67	15	16.67	40	44.44
Agree	16	17.78	12	13.33	12	13.33	40	44.44
Neutral	4	4.44	2	2.22	3	3.33	9	10.00
Disagree	0	0.00	1	1.11	0	0.00	1	1.11
Strongly Disagree	0	0.00	0	0.00	0	0.00	0	0.00
Total	30	33.33	30	33.33	30	33.33	90	100.00



**Figure 9-20: Specialized shariah certification**

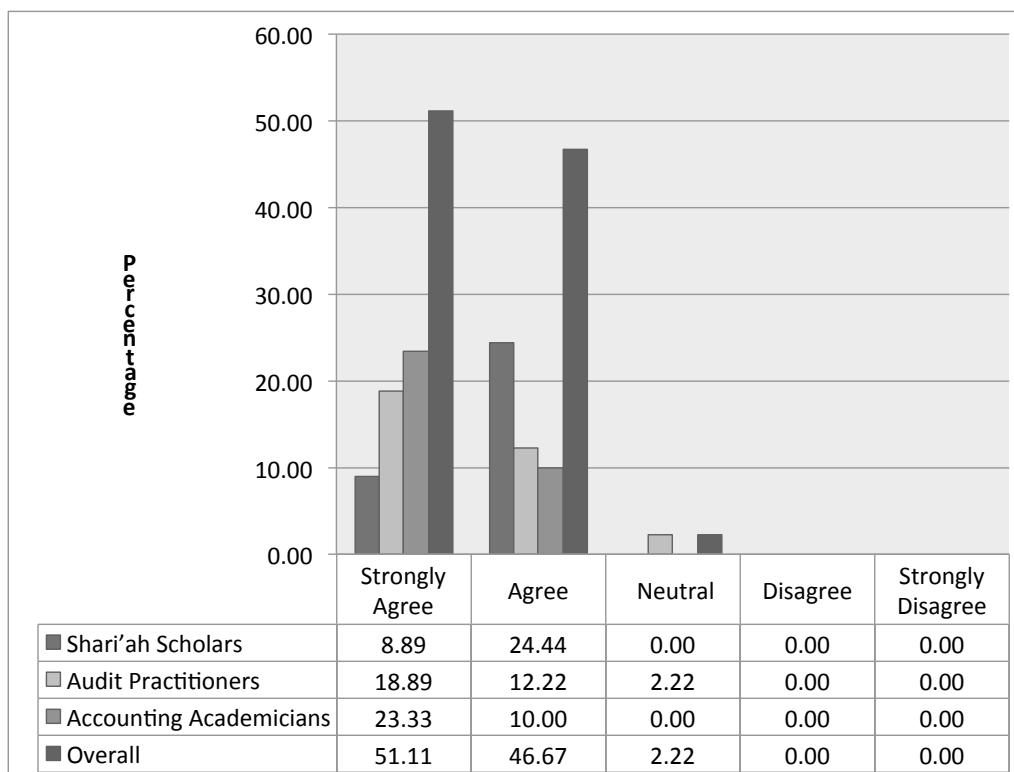
This graph shows that almost the entire respondents 88.88% feel that shariah auditors need to have specialized shariah certification qualification. Very few of the



respondents (1.11%) disagreed and no one of the respondents are strongly disagreed with this particular issue.

**Table 9-21:** Combination of Shari’ah and Accounting knowledge

	Shari’ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Strongly Agree	8	8.89	17	18.89	21	23.33	46	51.11
Agree	22	24.44	11	12.22	9	10.00	42	46.67
Neutral	0	0.00	2	2.22	0	0.00	2	2.22
Disagree	0	0.00	0	0.00	0	0.00	0	0.00
Strongly Disagree	0	0.00	0	0.00	0	0.00	0	0.00
Total	30	33.33	30	33.33	30	33.33	90	100.00

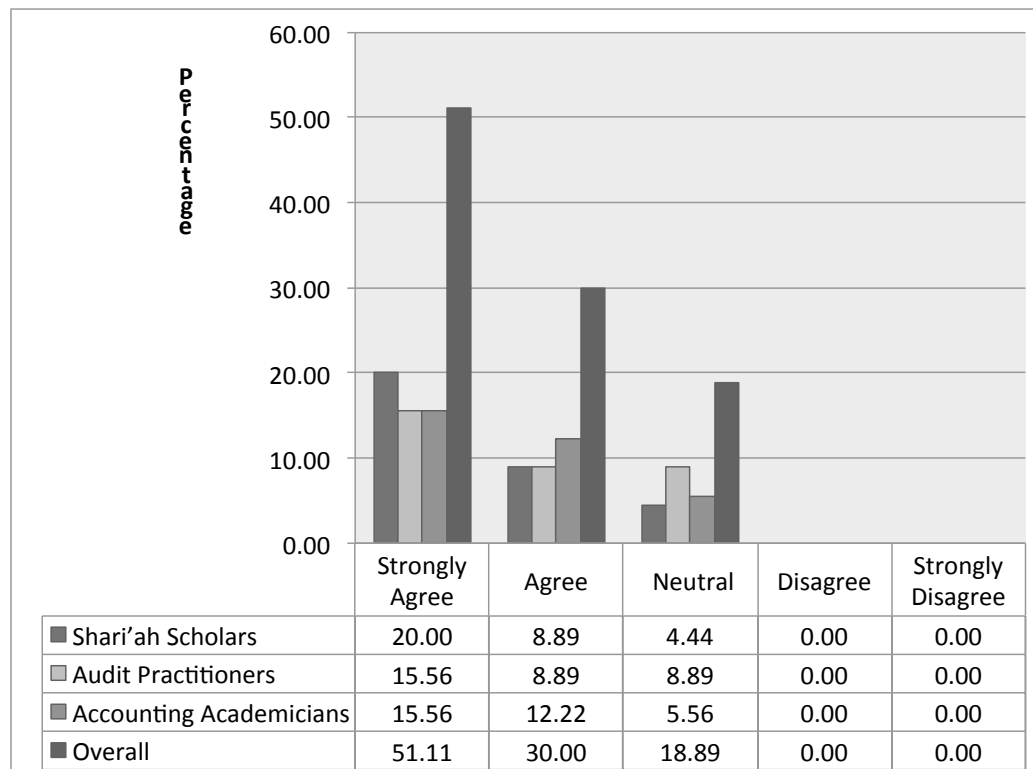


**Figure: 9-21: Combination of Shari’ah and Accounting knowledge**

Almost all the respondents think that shariah auditors should have knowledge in both shariah and accounting. However, while 51.11% respondents strongly agree that shariah auditors should be qualified in both shariah and accounting, 46.67% respondents agree with it. This graph also shows that no one among the respondents disagree with this particular issue.

**Table 9-22: Scrutinizing body for appointing shariah auditors.**

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Strongly Agree	18	20.00	14	15.56	14	15.56	46	51.11
Agree	8	8.89	8	8.89	11	12.22	27	30.00
Neutral	4	4.44	8	8.89	5	5.56	17	18.89
Disagree	0	0.00	0	0.00	0	0.00	0	0.00
Strongly Disagree	0	0.00	0	0.00	0	0.00	0	0.00
Total	30	33.33	30	33.33	30	33.33	90	100.00

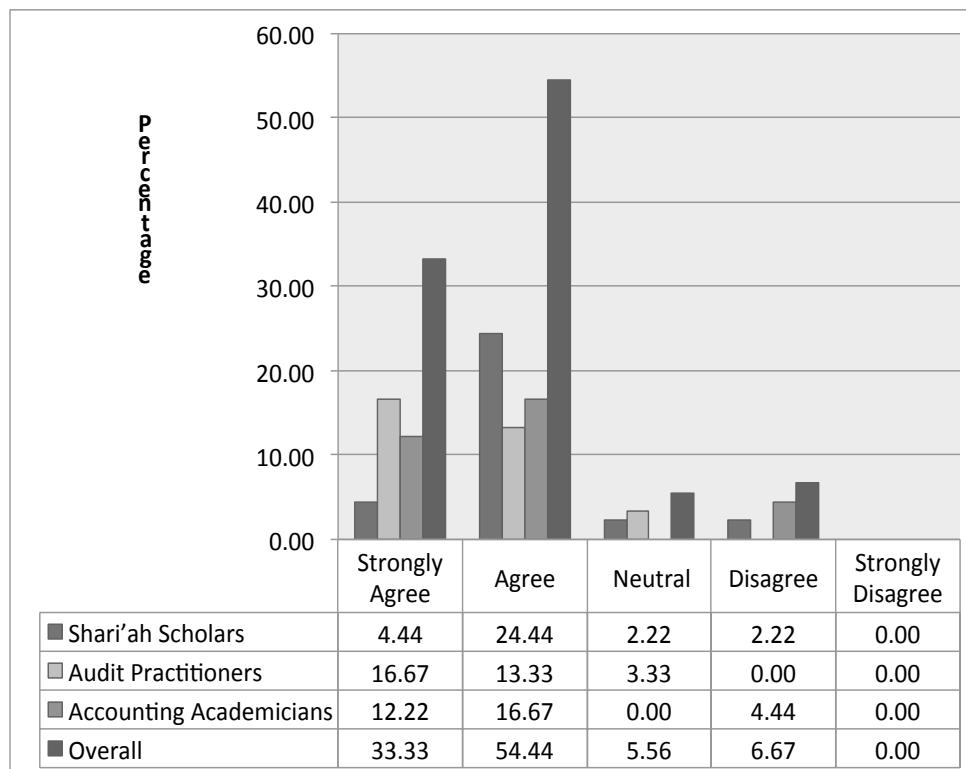


**Figure 9-22: Scrutinizing body for appointing shariah auditors**

There is a clear consistency of opinion among the respondents about this particular issue. 81.11% respondents think that there should be a body for scrutinizing the qualification and competence for the appointment of shariah auditors. Among the all respondents 51.11% strongly agree and 30% of the respondents are agree. However, a total of 18.89% of the respondents are neutral in this particular issue. This graph also shows that no one among the respondents disagree with this particular issue.

**Table 9-23: Shari'ah auditors' training in banking and Finance**

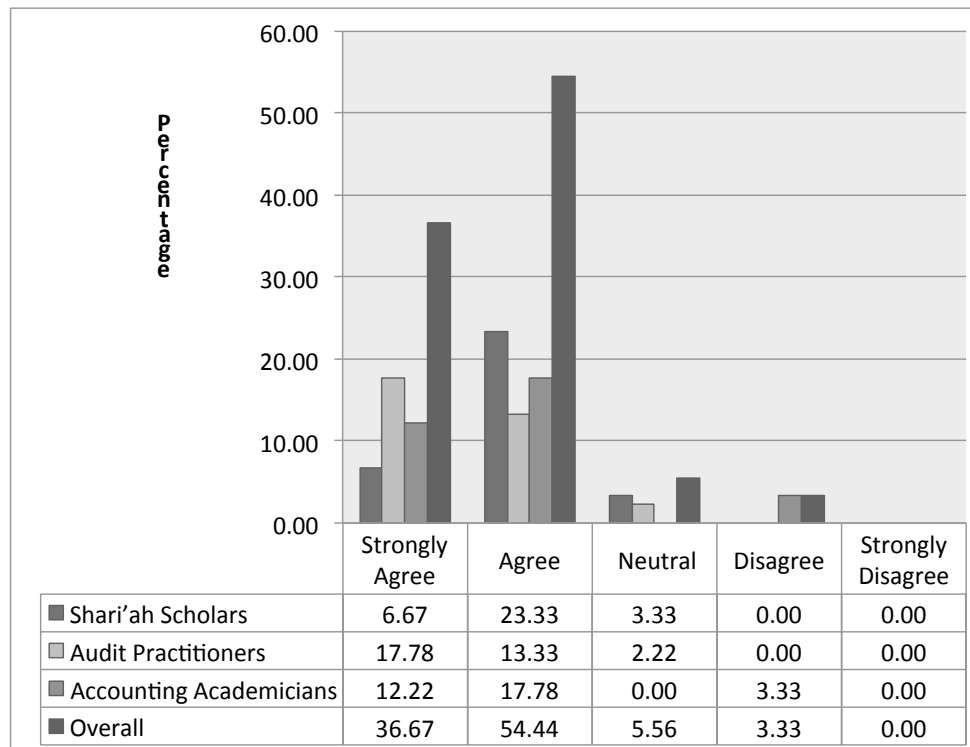
	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Strongly Agree	4	4.44	15	16.67	11	12.22	30	33.33
Agree	22	24.44	12	13.33	15	16.67	49	54.44
Neutral	2	2.22	3	3.33	0	0.00	5	5.56
Disagree	2	2.22	0	0.00	4	4.44	6	6.67
Strongly Disagree	0	0.00	0	0.00	0	0.00	0	0.00
Total	30	33.33	30	33.33	30	33.33	90	100.00

**Figure 9-23: Shari'ah auditors' training in banking and Finance**

There is a clear consistency of opinion among the respondents about this particular issue. This graph shows that while, 87.77% respondents feel the need of training for auditors in both banking and finance, 33.33% respondents strongly agree and 54.44% agree with this concept. This graph also shows that while, no one among the respondents strongly disagree with this particular issue, 5.56% of the respondents are totally neutral.

**Table 9-24:** Shari’ah auditors’ training on audit related risks and issues

	Shari’ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Strongly Agree	6	6.67	16	17.78	11	12.22	33	36.67
Agree	21	23.33	12	13.33	16	17.78	49	54.44
Neutral	3	3.33	2	2.22	0	0.00	5	5.56
Disagree	0	0.00	0	0.00	3	3.33	3	3.33
Strongly Disagree	0	0.00	0	0.00	0	0.00	0	0.00
Total	30	33.33	30	33.33	30	33.33	90	100.00

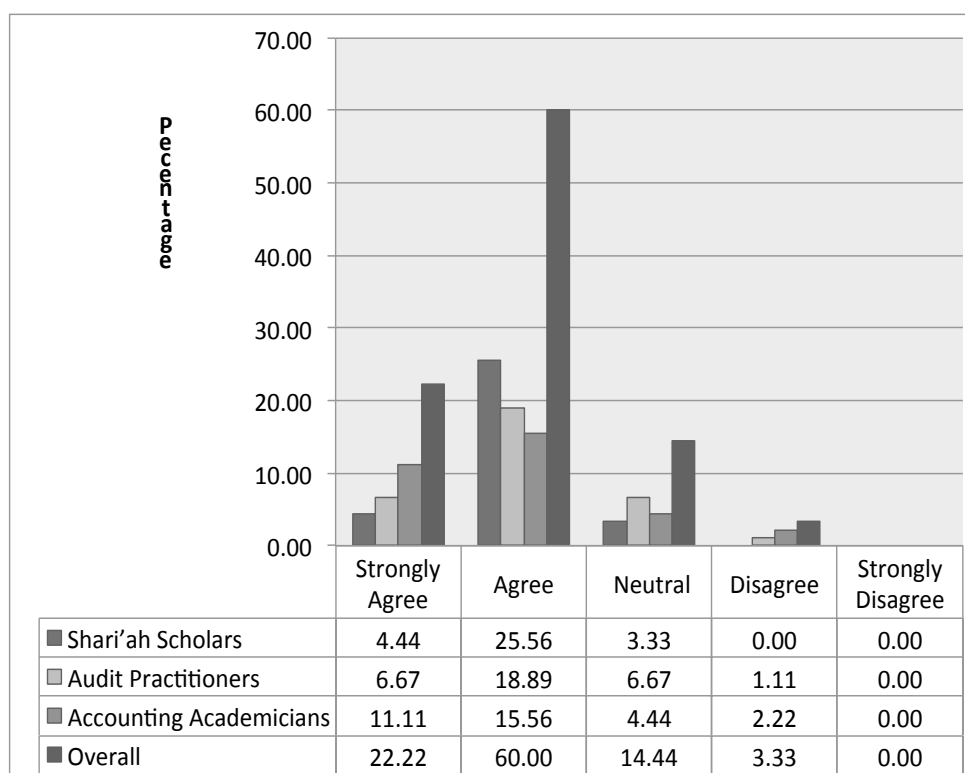


*Figure 9-24: Shari’ah auditors’ training on audit related risks and issues*

91.11% respondents think that the shariah auditors should be properly trained on audit related risks and issues. 36.67% respondents strongly agree and 54.44% agree with this concept. This graph also shows that while, no one among the respondents strongly disagree with this particular issue, 5.56% of the respondents are totally neutral.

**Table 9-25: Shari’ah audit is broader than conventional audit**

	Shari’ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Strongly Agree	4	4.44	6	6.67	10	11.11	20	22.22
Agree	23	25.56	17	18.89	14	15.56	54	60.00
Neutral	3	3.33	6	6.67	4	4.44	13	14.44
Disagree	0	0.00	1	1.11	2	2.22	3	3.33
Strongly Disagree	0	0.00	0	0.00	0	0.00	0	0.00
Total	30	33.33	30	33.33	30	33.33	90	100.00

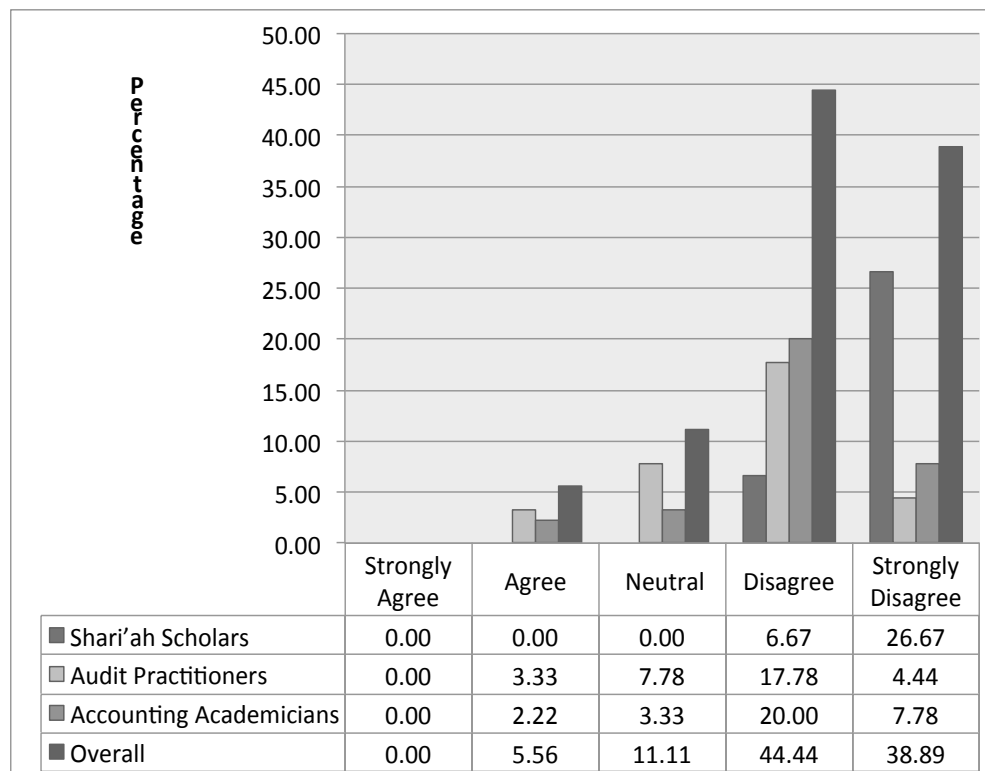


**Table 9-25: Shari’ah audit is broader than conventional audit**

While 82.22% respondents think that shariah audit covers broader areas than conventional audit, only scant 3.33% respondents do not agree with this concept. This graph also shows that 22.22% respondents strongly agree and 60% agree with this concept. This graph also shows that while, no one among the respondents strongly disagree with this particular issue, 14.44% of the respondents are totally neutral.

**Table 9-26: Shari'ah audit and Financial Statement audit**

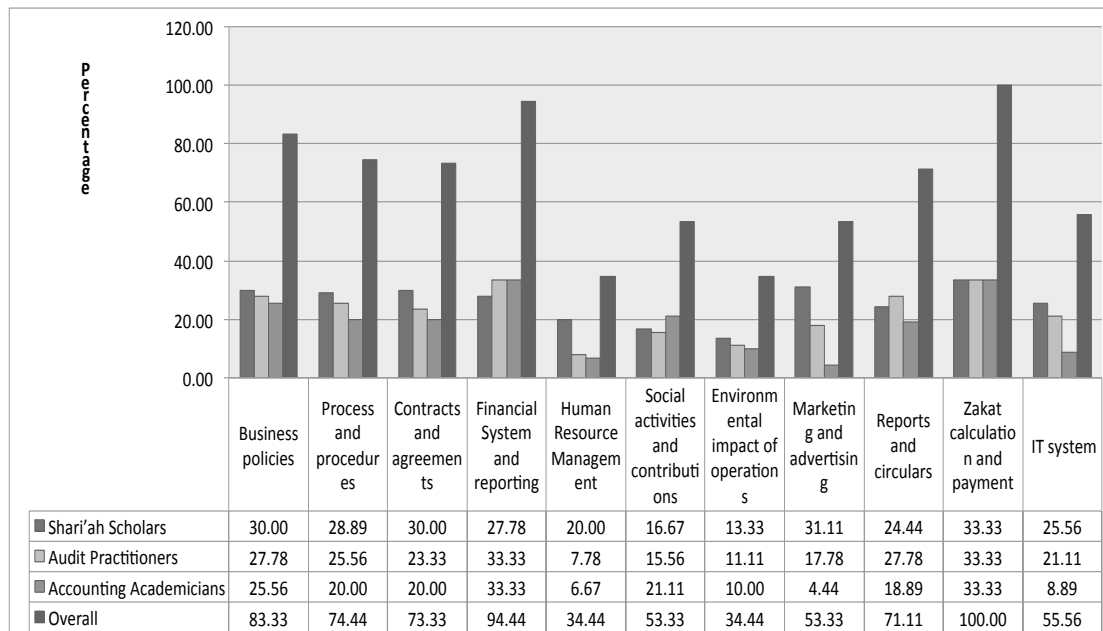
	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Strongly Agree	0	0.00	0	0.00	0	0.00	0	0.00
Agree	0	0.00	3	3.33	2	2.22	5	5.56
Neutral	0	0.00	7	7.78	3	3.33	10	11.11
Disagree	6	6.67	16	17.78	18	20.00	40	44.44
Strongly Disagree	24	26.67	4	4.44	7	7.78	35	38.89
Total	30	33.33	30	33.33	30	33.33	90	100.00

**Figure 9-26: Shari'ah audit and Financial Statement audit**

This graph shows that 83.33% respondents think that sharia audit should not be limited to the financial statement audit, only scant 5.56% respondents do agree with this concept. This graph also shows that 38.89% respondents strongly disagree and 44.44% disagree with this concept. This graph also shows that while, no one among the respondents strongly agrees with this particular issue, 11.11% of the respondents are totally neutral.

**Table 9-27: Areas to be covered by “Shari’ah Audit” (n=90) (Multiple answer)**

	Shari’ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Business policies	27	30.00	25	27.78	23	25.56	75	83.33
Process and procedures	26	28.89	23	25.56	18	20.00	67	74.44
Contracts and agreements	27	30.00	21	23.33	18	20.00	66	73.33
Financial System and reporting	25	27.78	30	33.33	30	33.33	85	94.44
Human Resource Management	18	20.00	7	7.78	6	6.67	31	34.44
Social activities and contributions	15	16.67	14	15.56	19	21.11	48	53.33
Environmental impact of operations	12	13.33	10	11.11	9	10.00	31	34.44
Marketing and advertising	28	31.11	16	17.78	4	4.44	48	53.33
Reports and circulars	22	24.44	25	27.78	17	18.89	64	71.11
Zakat calculation and payment	30	33.33	30	33.33	30	33.33	90	100.00
IT system	23	25.56	19	21.11	8	8.89	50	55.56



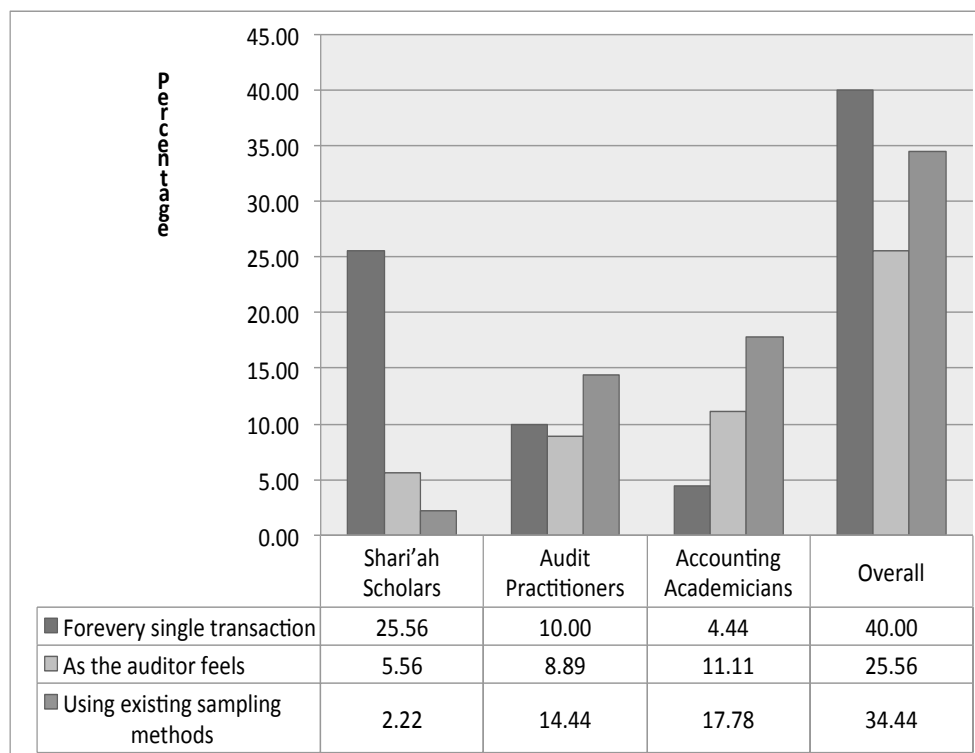
**Table 9-27: Areas to be covered by “Shari’ah Audit” (n=90) (Multiple answer)**

In the questionnaire, the respondents were given an option to select multiple answer of that question. Majority of the respondents picked multiple answers in this case. According to them all the areas mentioned (a) Business plans (b) Procedures (c) Agreements (d) Financial systems and reporting (e) HRM (f) Charities (g) Environmental effect of operations (h) Marketing (i) Public relations (j) Reports (k) Zakat computation and disbursement (l) Information Technology Application systems

etc.) in the questionnaire should be covered by the shariah audit.

**Table 9-28:** Performing “Shari’ah Audit” in Islamic banks

	Shari’ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
For every single transaction	23	25.56	9	10.00	4	4.44	36	40.00
As the auditor feels	5	5.56	8	8.89	10	11.11	23	25.56
Using existing sampling methods	2	2.22	13	14.44	16	17.78	31	34.44
Total	30	33.33	30	33.33	30	33.33	90	100.00



**Figure 9-28:** Performing “Shari’ah Audit” in Islamic banks

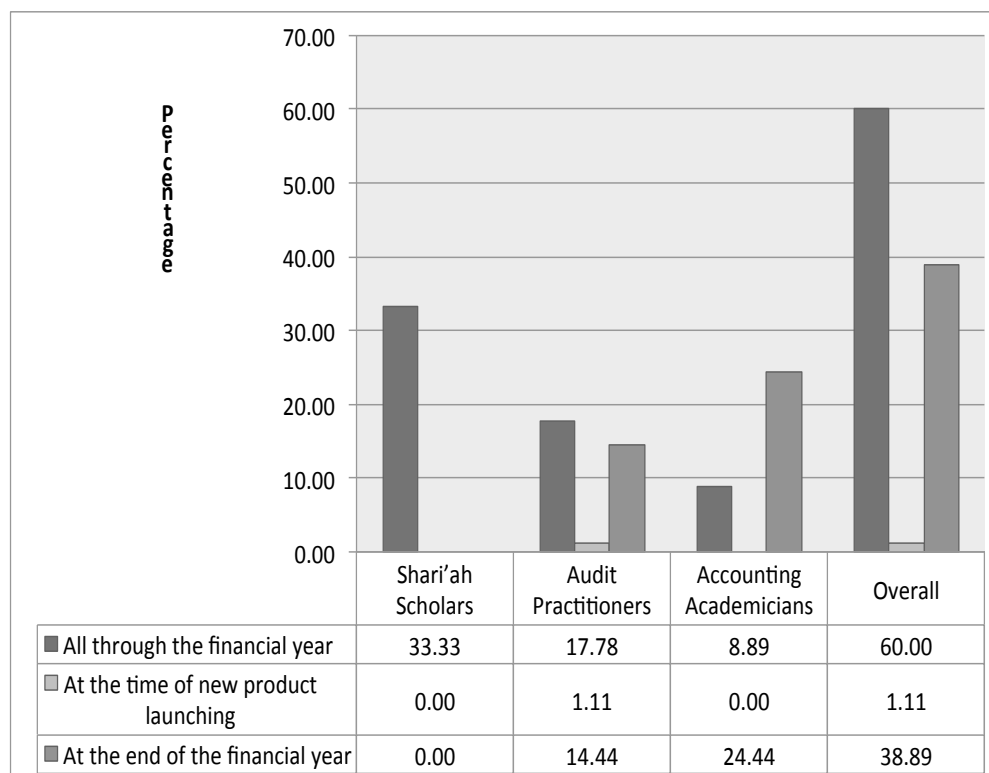
There is a clear difference of opinion among the respondents about this particular issue. While the shariah scholars (25.56%) preferred every single transaction, the audit practitioners (14.44%) and accounting academicians (17.78%) preferred the



existing sampling method for conducting shariah audit in islami banks. However, about one-fourth of the total respondents (25%) believe that shariah audit should be done according to the will of the auditor.

**Table 9-29: Schedule of Shariah auditing**

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
All through the financial year	30	33.33	16	17.78	8	8.89	54	60.00
At the time of new product launching	0	0.00	1	1.11	0	0.00	1	1.11
At the end of the financial year	0	0.00	13	14.44	22	24.44	35	38.89
Total	30	33.33	30	33.33	30	33.33	90	100.00



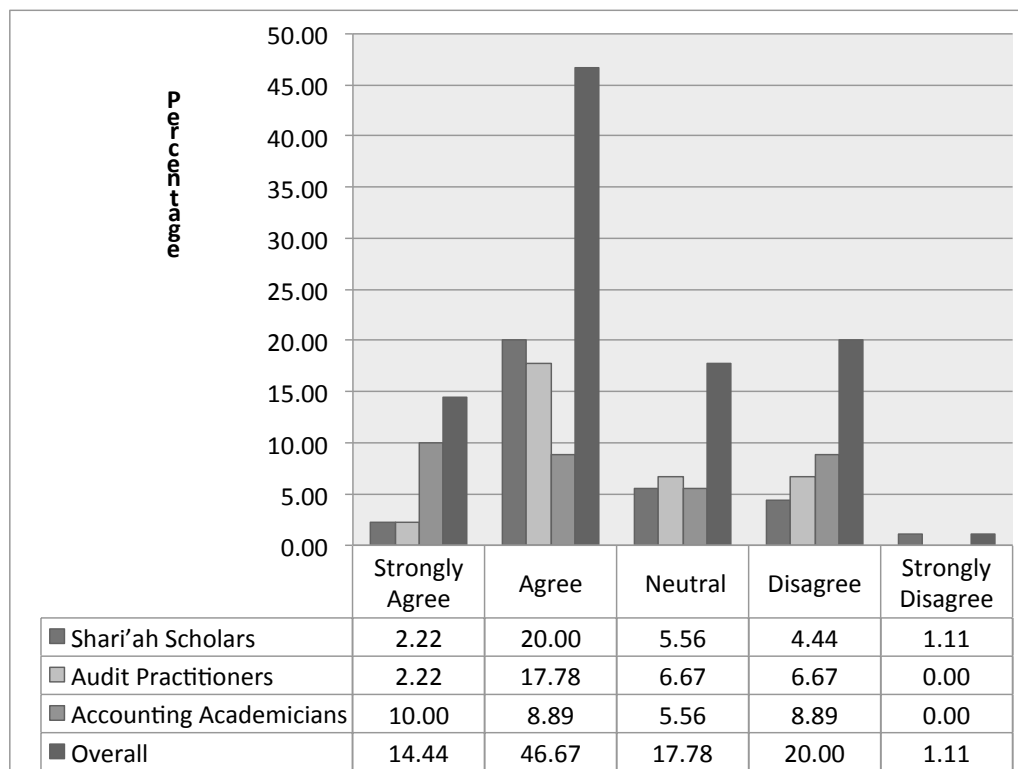
**Figure 9-29: Schedule of Shariah auditing**

There is a clear difference of opinion among the respondents about this particular issue. While all shariah scholars (33.33%) choose the schedule of shariah audit as all

through the financial year, accounting academicians (24.44%) feel that it should be done at the end of the financial year. However, the audit practitioners were divided in their opinion of the timing of shariah auditing. Among them 17.78% choose the schedule of shariah audit as all through the financial year and 14.44% feel that it should be done at the end of the financial year. Only scant 1.11% respondents choose the schedule of shariah audit at the time of new product launching.

**Table 9-30:** The IT providing information about shariah audit

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Strongly Agree	2	2.22	2	2.22	9	10.00	13	14.44
Agree	18	20.00	16	17.78	8	8.89	42	46.67
Neutral	5	5.56	6	6.67	5	5.56	16	17.78
Disagree	4	4.44	6	6.67	8	8.89	18	20.00
Strongly Disagree	1	1.11	0	0.00	0	0.00	1	1.11
Total	30	33.33	30	33.33	30	33.33	90	100.00

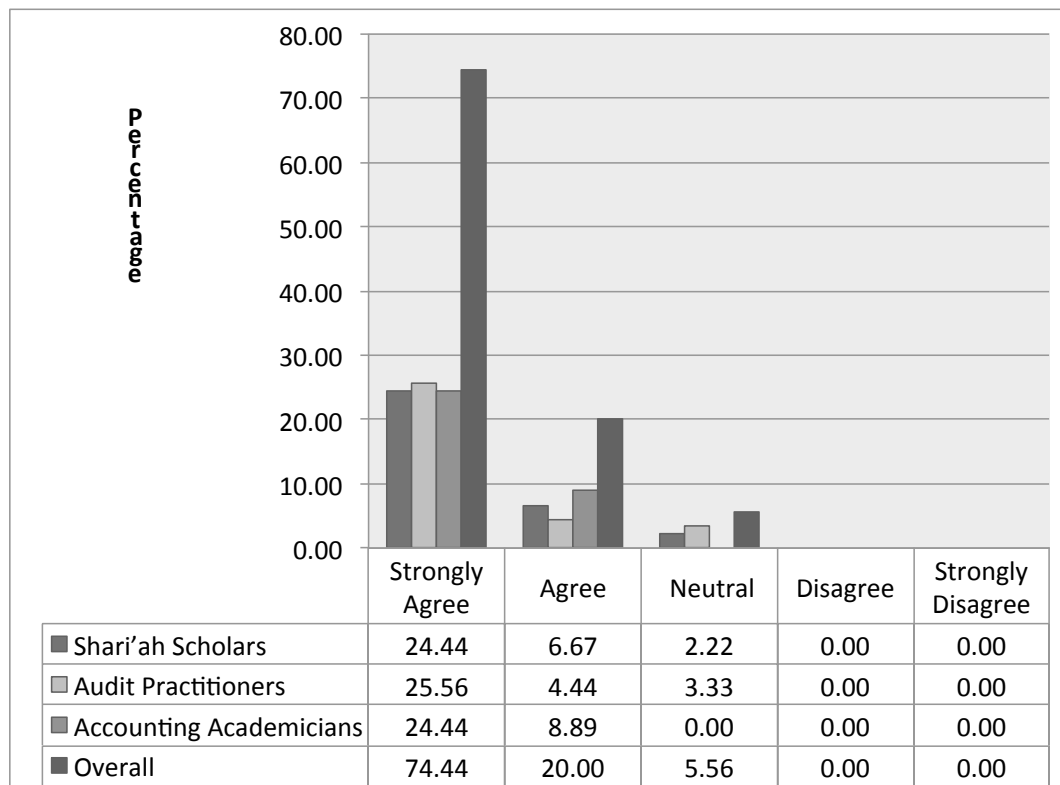


**Figure 9-30:** The IT providing information about shariah audit

61.11% of the respondents are positive about the performance of IT system providing the shariah auditors with necessary data and information to complete the audit. Among these respondents 46.67% agree and 14.44% responds strongly agree with the positive performance of IT system. However, 21.11% respondents feel negative about the performance of IT system providing information about the Shariah audit.

**Table 9-31:** Independence of the Shariah auditors

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Strongly Agree	22	24.44	23	25.56	22	24.44	67	74.44
Agree	6	6.67	4	4.44	8	8.89	18	20.00
Neutral	2	2.22	3	3.33	0	0.00	5	5.56
Disagree	0	0.00	0	0.00	0	0.00	0	0.00
Strongly Disagree	0	0.00	0	0.00	0	0.00	0	0.00
Total	30	33.33	30	33.33	30	33.33	90	100.00

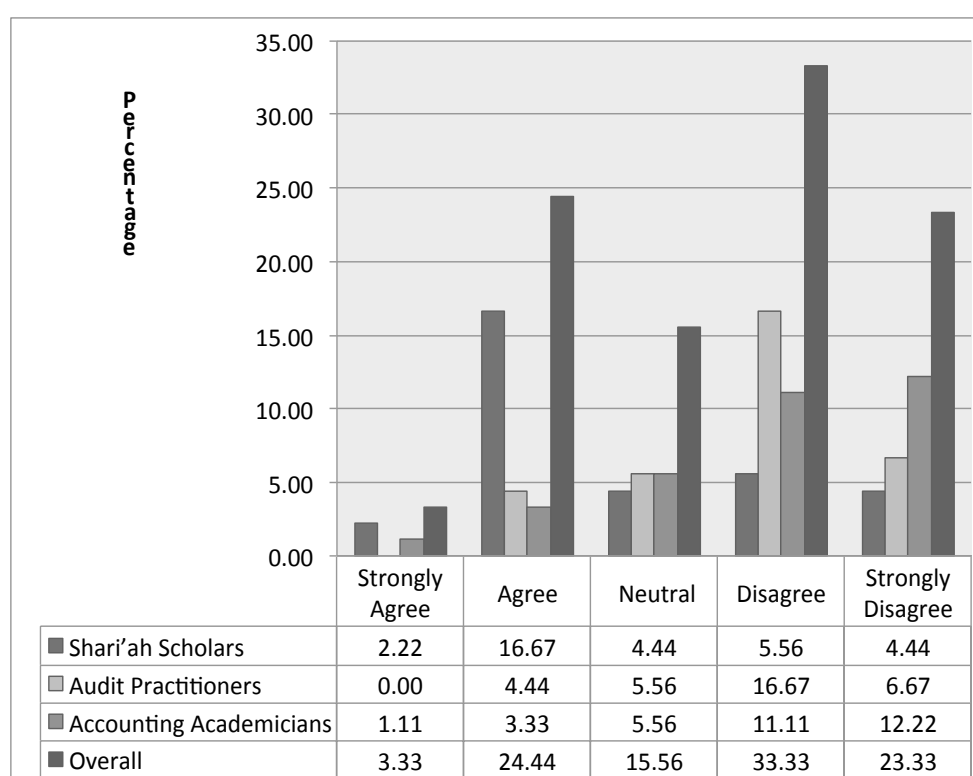


**Figure 9-31:** Independence of the Shariah auditors

Almost all the respondents 94.44% are in favor of the independence of the shariah auditors from the organization they work for. Among these respondents 20% agree and 74.44% responds strongly agree with the independence of the shariah auditors. However, no respondent disagreed with the independence of shariah auditor in the organization they work for.

**Table 9-32:** Number of members of Shariah Committee

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Strongly Agree	2	2.22	0	0.00	1	1.11	3	3.33
Agree	15	16.67	4	4.44	3	3.33	22	24.44
Neutral	4	4.44	5	5.56	5	5.56	14	15.56
Disagree	5	5.56	15	16.67	10	11.11	30	33.33
Strongly Disagree	4	4.44	6	6.67	11	12.22	21	23.33
Total	30	33.33	30	33.33	30	33.33	90	100.00

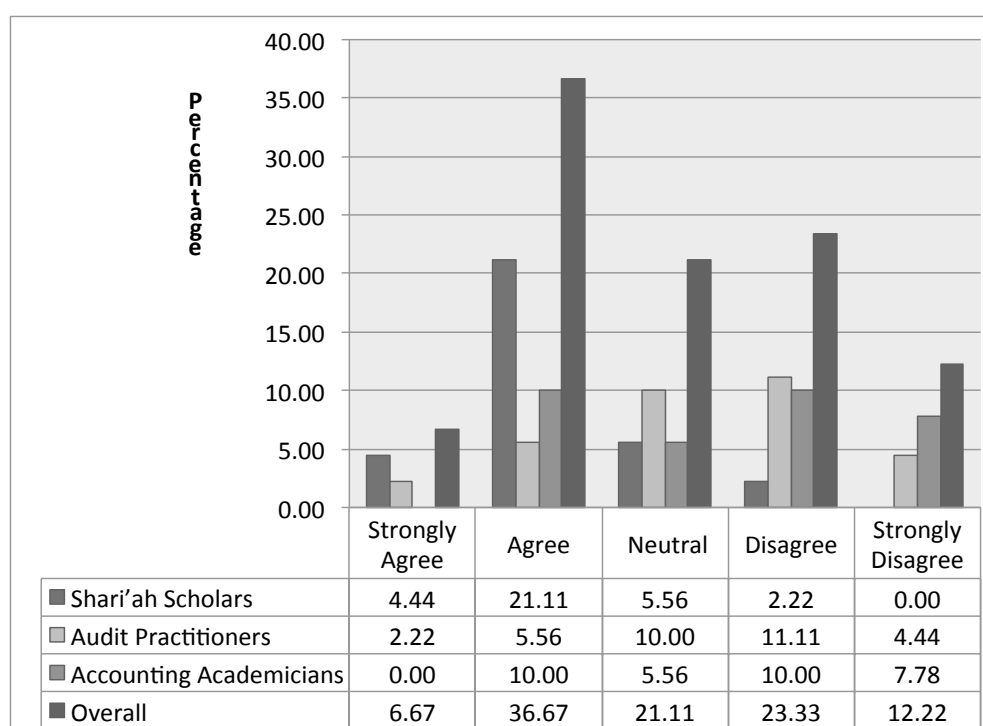


*Figure 9-32: Number of members of Shariah Committee*

The research has got a very varied opinion about this aspect. 27.77% of the respondents say that shariah committee has sufficient members. Among these respondents 3.33% agree and 24.44% responds strongly agree with the number of members in the shariah committee. On the other hand, 56.66% of the respondents say that the shariah committees do not have sufficient members. Among these respondents 33.33% disagree and 23.33% responds disstrongly agree with this particular issue. However, 21.11% respondents feel negative. However, quite a large number of respondents (15.56%) are neutral about this issue.

**Table 9-33: Islamic Banks performance in promoting shari’ah audit**

	Shari’ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Strongly Agree	4	4.44	2	2.22	0	0.00	6	6.67
Agree	19	21.11	5	5.56	9	10.00	33	36.67
Neutral	5	5.56	9	10.00	5	5.56	19	21.11
Disagree	2	2.22	10	11.11	9	10.00	21	23.33
Strongly Disagree	0	0.00	4	4.44	7	7.78	11	12.22
Total	30	33.33	30	33.33	30	33.33	90	100.00

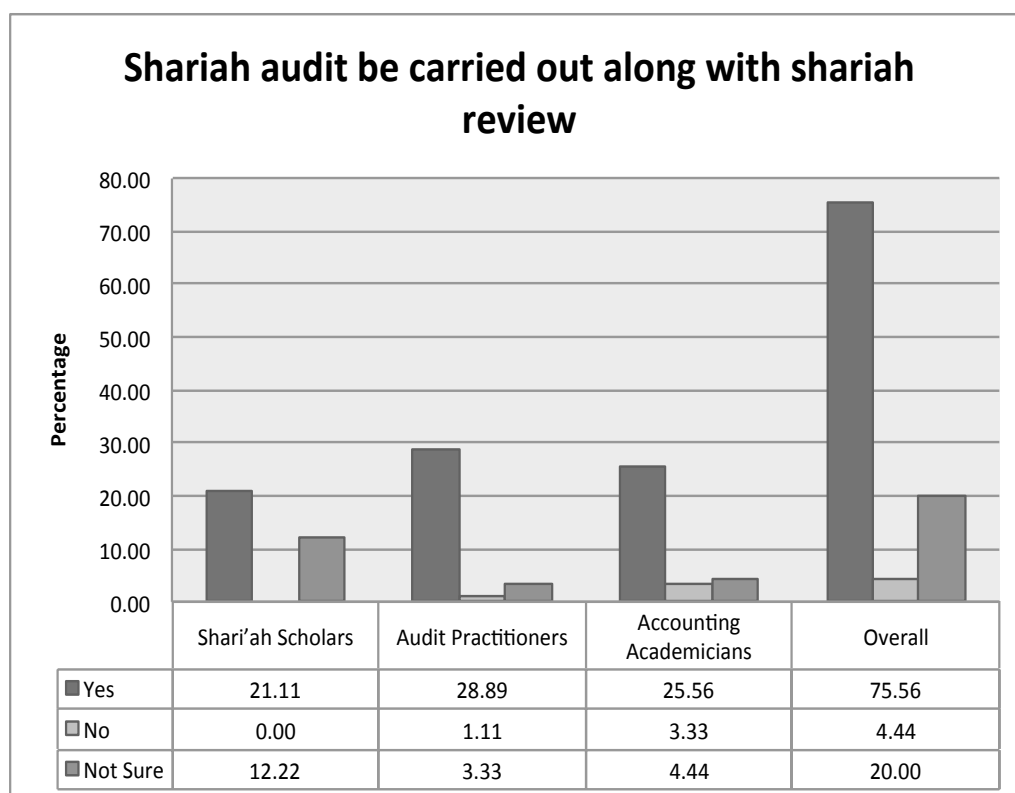


**Figure 9-33: Islamic Banks performance in promoting shari’ah audit**

The respondents gave a mixed response to this proposal. While the shariah scholars are largely in favor (4.44% strongly agree and 21.11% strongly disagree) of the bank's performance in promoting shariah audit, the audit practitioners (11.11 disagree and 4.44% strongly disagree) and accounting academicians (10% disagree and 7.78% strongly disagree) are largely against the performance of the banks. However, among the total respondents 22.11% remained neutral.

**Table 9.34:** 'Shariah Audit' carrying out along with shariah review

	Shari'ah Scholars		Audit Practitioners		Accounting Academicians		Overall	
	F	%	F	%	F	%	F	%
Yes	19	21	26	29	23	26	68	76
No	0	0	1	1	3	3	4	4
Not Sure	11	12	3	3	4	4	18	20
Total	30	33	30	33	30	33	90	100



**Figure 9.34:** 'Shariah Audit' carrying out along with shariah review

There is a clear difference of opinion among the respondents about this particular issue. This graph shows that majority of the respondents (75.56%) of the respondents opined that there should be shariah audit side-by-side shariah review. Among them 21.11 % of the respondents of shariah scholars, 28% of the respondents of audit practitioners and 25.56% of the respondents of accounting academicians argued that there should be a shariah audit along with shariah review in the Islamic banks in Bangladesh. However, 20% of the respondents (among them 12.22% shariah scholars, 3.33% audit practitioners and 4.44% accounting academicians) do not know there might be a shariah audit along with shariah review or not.

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## **Chapter-10: Cost-benefit analysis of implementing shariah auditing**

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*While conducting the research, I carried out open-ended interviews with the respondents, which threw light on some important aspects of implementing shariah audit in Bangladeshi Islamic banks. Chapter ten conducts a cost-benefit analysis of implementing shariah audit. For doing this economic theory of transaction and monitoring costs, agency theory and residual claimants theory have been analyzed.*

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### **10.1 Theories of transaction and monitoring costs**

The term ‘Transaction Costs’ can be defined as “the economic equivalent of *friction* in physical systems” (Williamson, 1985). In general, the cost for “running economic systems” Transaction costs includes *ex-ante* costs such as (i) finding the right partners, (ii) negotiating prices, (iii) drafting and writing appropriate contracts, and *ex-post* costs of (iv) monitoring, (v) enforcing the contract and (vi) disputing and contestation (Suzuki Y. , 2005). Coordination and motivation problem in different organization raise transaction costs (Milgrom & Roberts, 1992).

The theories of transaction and monitoring costs can be seen from two different perspectives: (1). The conventional audit practitioners, who carryout ex-post audits of the Islamic banks in Bangladesh. (2) The members of Shariah Supervisory Committee (SSC), who carryout ex-ante shariah review of the islamic banks in Bangladesh.

#### **10.1.1 The view of conventional audit practitioners**

The conventional audit practitioners argued that in order to ensure ex-ante and ex-post shariah compliance, there is a need of implementing shariah audit along with shariah review. They also argued that, as there is no professional shariah audit body available



in Bangladesh, the interest-free banks in Bangladesh have to establish an independent body, which will regulate and guide to the shariah auditor. However, they are also concerned about transaction and monitoring costs for implementing shariah audit. They opined that the transaction costs would be huge for setting-up this new professional shariah audit body first and then contracting with one of these shariah audit firm. They also opined that, changes from conventional ex-post audit to ex-post shariah audit would require a lot of initial monitoring costs. The respondents of conventional audit practitioners and accounting academicians think that because of the above-mentioned transaction and monitoring costs, Islamic banks in Bangladesh are unwilling to carry out shariah audit instead of or along with shariah review.

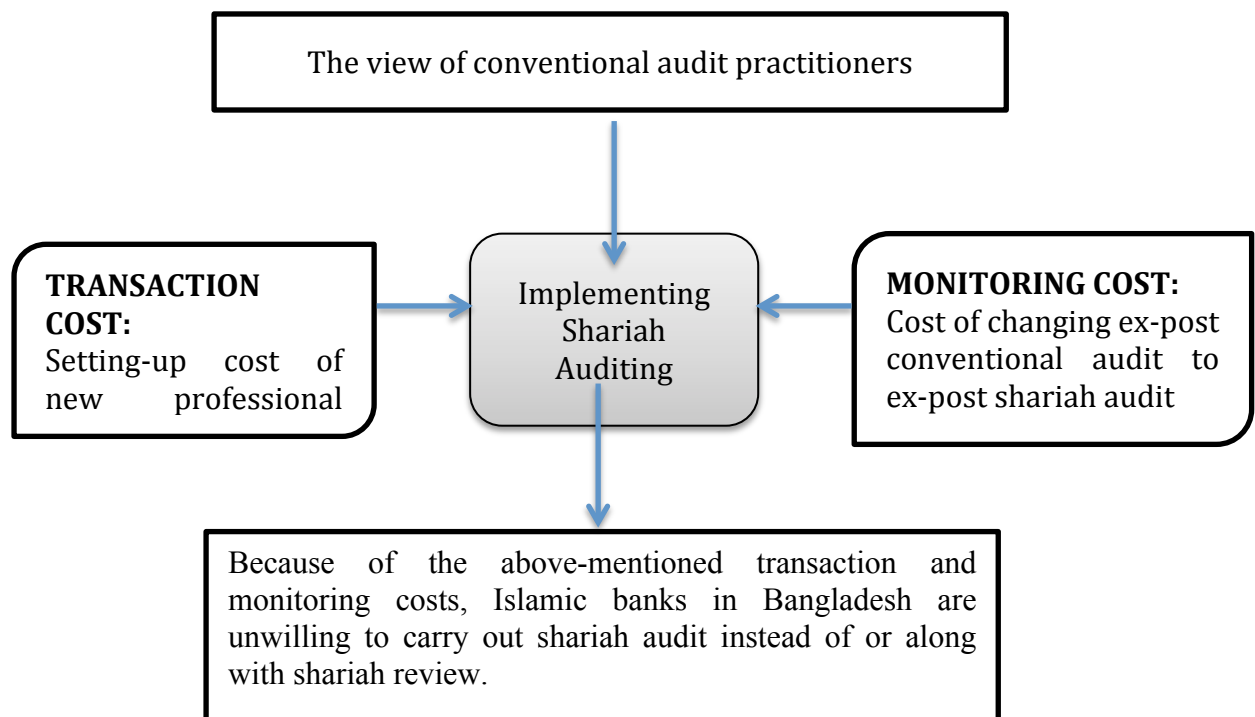
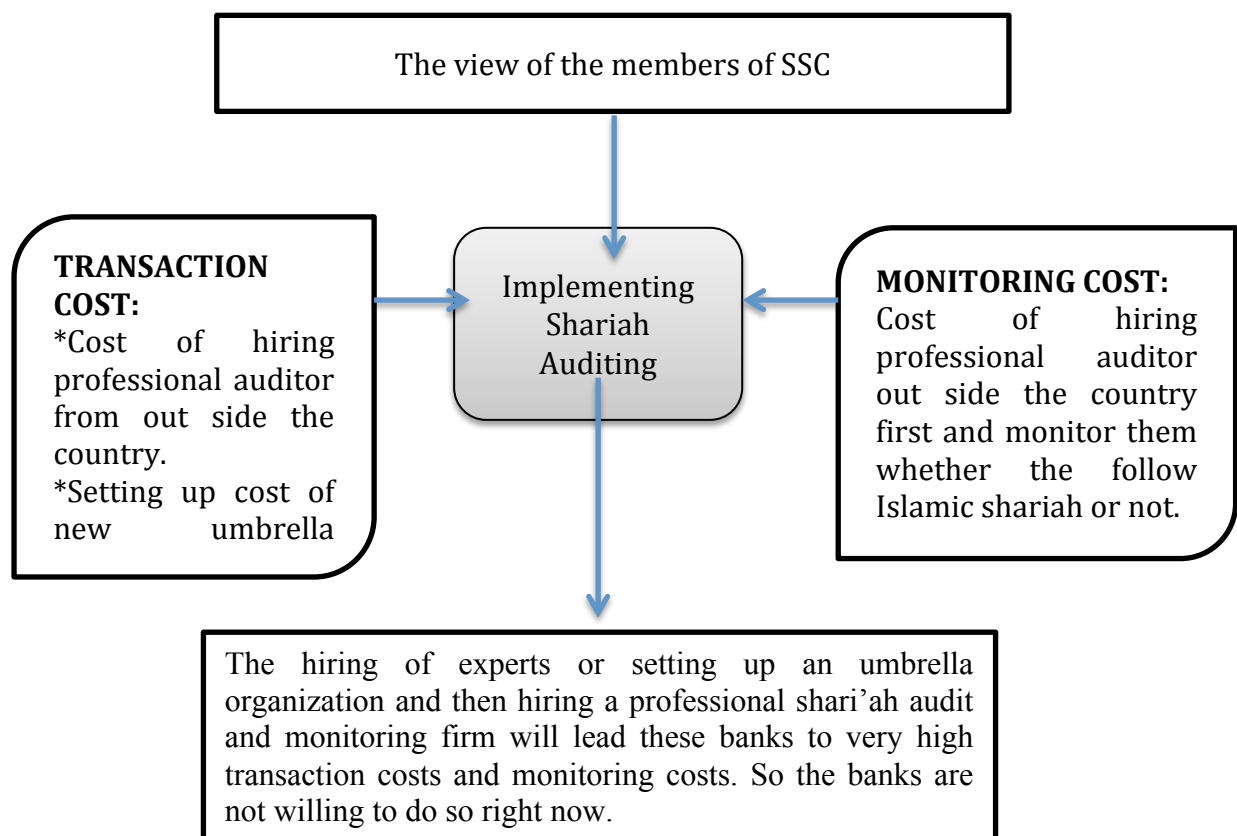


Figure 10-1: The view of conventional audit practitioners

### 10.1.2 The view of Shariah Supervisory Committee

The members of the SSC know very well that they are carrying out shariah review that is not good enough to ensure ex-post shariah compliance. So they think that there should be a shariah audit along with shariah review. However, they are also concerned about transaction and monitoring costs for implementing shariah audit. They think that, as there is no professional shariah audit firm available in Bangladesh, Islamic banks in Bangladesh have to hire professional shariah auditors from outside the country, which will lead to huge transaction costs. At the same time, they also argued that, hiring or setting up a new professional audit firm and monitoring them will also lead to huge initial monitoring costs. The hiring of experts or setting up an umbrella organization and then hiring a professional shari'ah audit and monitoring firm will lead these banks to very high transaction costs and monitoring costs. So the banks are not willing to do so right now.



**Figure 10-2: The view of the members of SSC**

## 10.2 Agency Theory

Agency theory is the first and foremost concern of Islamic finance corporate governance. The theoretical structure of IFIs poses a greater need for transparency to its investment account holders. However, ‘incentive approach’ solve principal-agent problem in the organization (Suzuki Y. , 2011).

### 10.2.1 Causes of Agency problem In Islamic banks

*Agency problem occurs when:*

1. The Islamic bank / management do not establish shariah audit functions to protect investment account holders interest.
2. There is ex-post asymmetric information between bank management and investment account holders.
3. The investment account holders have lack of opportunity to access information.
4. The investment account holders have lack of influence on banks ‘management decision.

When the management of an Islamic bank would appoints an individual shariah audit firm there might be some conflicting issues raised between the management and the shareholders (investment account holders) as well.

### 10.2.2 Principal-agent problem

- **Principal:** The investment account holders need to ensure that the Islamic banks are running their operations by following Islamic shariah properly. As a result, they would want ex-post shariah audit. However, they are even ready to bear the transaction and monitoring costs by taking lesser profit from their investment.

- **Agent:** However, , the management of the interest-free bank would see it from a different angel. They may view it as a huge burden to appoint shariah auditor because of the involvement of huge transaction and monitoring costs, which will lead lesser profit for bank and lesser income for themselves.

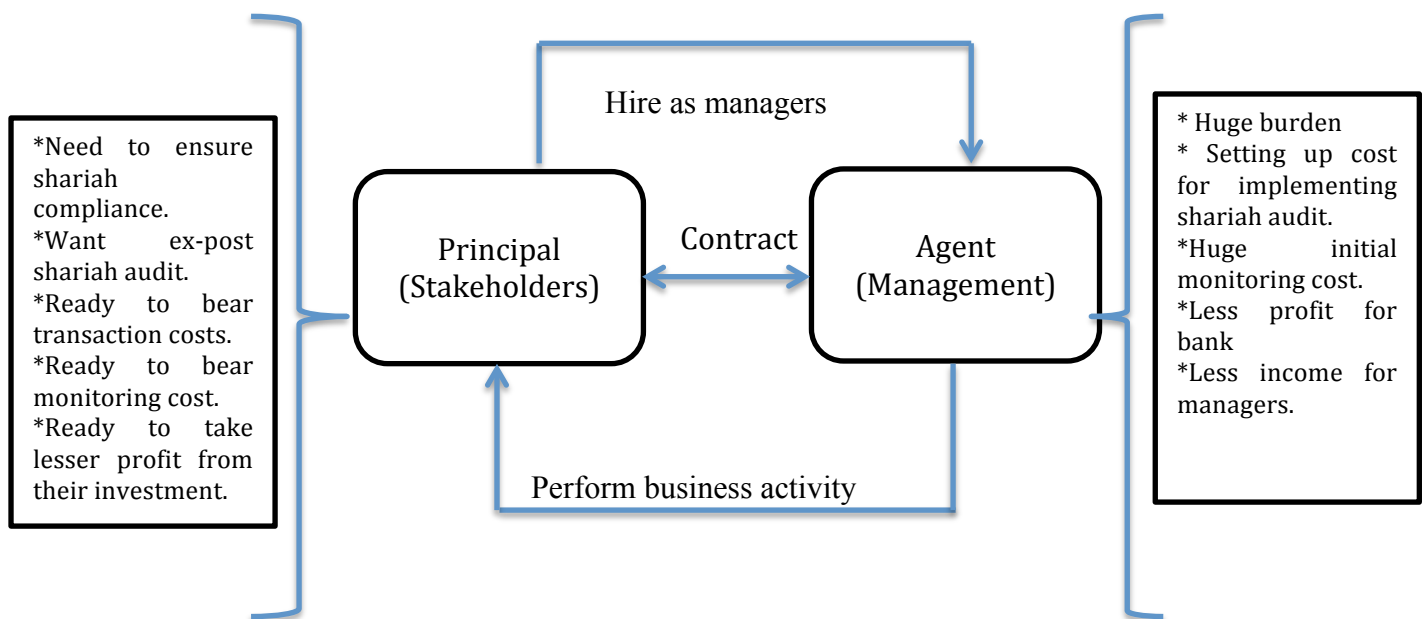


Figure 10-3: Principal agent problem for implementing shariah auditing

In another point of view, when the management of an interest-free bank appoints an individual shariah audit firm there may be some conflicting issues between the management and the shareholders (investment account holders) as well. The shareholders (investment account holders) would want to be ensured that the bank they are transacting with is following the Islamic shariah properly. They want to see that the bank is following shariah compliance, which will guarantee them that they are not violating any of the Islamic principles by transacting with the bank. As a result they would want a proper shariah ex-post audit in the Islamic bank. However, they are even ready to bear the cost of appointing the external professional shairah audit firm and monitoring firm by taking lesser profit from their investment. At the same time,

the management of the Islamic banks would see it from a different angle. They may view it as a huge burden to appoint the external professional shariah audit firm and monitoring firm, which will lead to lesser profit for the bank and lesser income for them.

### 10.3 Residual claimants

Residuals are the portion that remains after the deduction of all costs. Both the owner (s) and the management claim the residuals. The owner of the firm is the residual claimant as he is the one who is entitled to receive any net income that the firm produce (Milgrom & Roberts, 1992). According to (Suzuki Y. , 2011), The owner of an organization in the form of shareholders have the incentive to monitor the managers of the organization because the proper monitoring of the manager brings them higher residuals in the form of higher dividends.

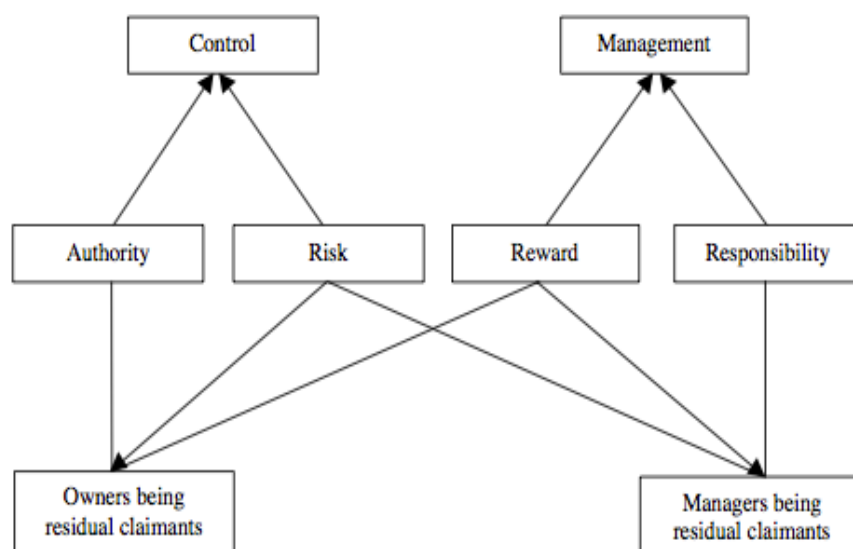


Figure 10-4: Residual Claimants

In case of running the business of an Islamic bank, there may be two major parties: the owners of the bank and the management. The owners appoint the management to run the business. So they have a clear control over the management. They also bear the risk of operation. On the other hand, the management of the bank has the responsibilities of operating the bank's business. They may not share the risk of operating the business but they will carry out the risk of business. However, both the parties claim the residuals for being involved with risk and they both claim the reward. The owners claim the residuals because of their authority over the management and the management claims the residuals because of their responsibilities they carry out while operating the bank.

If an external professional shariah auditing and monitoring firm is appointed to do the ex-post shariah audit in an Islamic bank there will be a huge transition and monitoring cost which will immediately reduce the profit of the bank. As the profit decreases, the residuals also decrease. As the residuals decrease, shares of both the owners and the management will also immediately decrease. So, neither the owners of the Islamic banks nor the management of the Islamic banks wants to implement shariah. However, though it will increase initial transaction costs and monitoring costs, it will also ensure proper shari'ah compliance. Ultimately, the common clients (mass people) of the islamic banks in Bangladesh will be ensured that these banks maintain all the shari'ah principles of Islam. They will have a bigger trust in these islamic banks which will result in an increase of the number of clients and business. As a result, these banks will earn a hefty profit in the long run.

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## Chapter-11: Need of Shariah Auditing

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*Chapter eleven talks about the necessity of shariah audit in Bangladeshi Islamic banks. It talks about the problems Islamic banks are having because of the absence of shariah audit. It also explains the difference between shariah review and shariah audit. It explains the issues related to shariah audit and necessity of shariah auditors. The chapter ends with the shariah audit.*

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### 11.1 Necessity of Shariah auditing

The need of shariah auditing can be explained from four different aspects. The first aspect describes about the bottlenecks of IFIs because of the absence of shariah auditing. The next dimension shows a clear difference between shariah review (current practice) and shariah auditing (proposed). The third aspect describes the need of shariah auditing in order to ensure ex-post shariah compliance. The final dimension describes the need of shariah auditing because of the existence of some conflicting issues between conventional accounting and Islamic accounting.

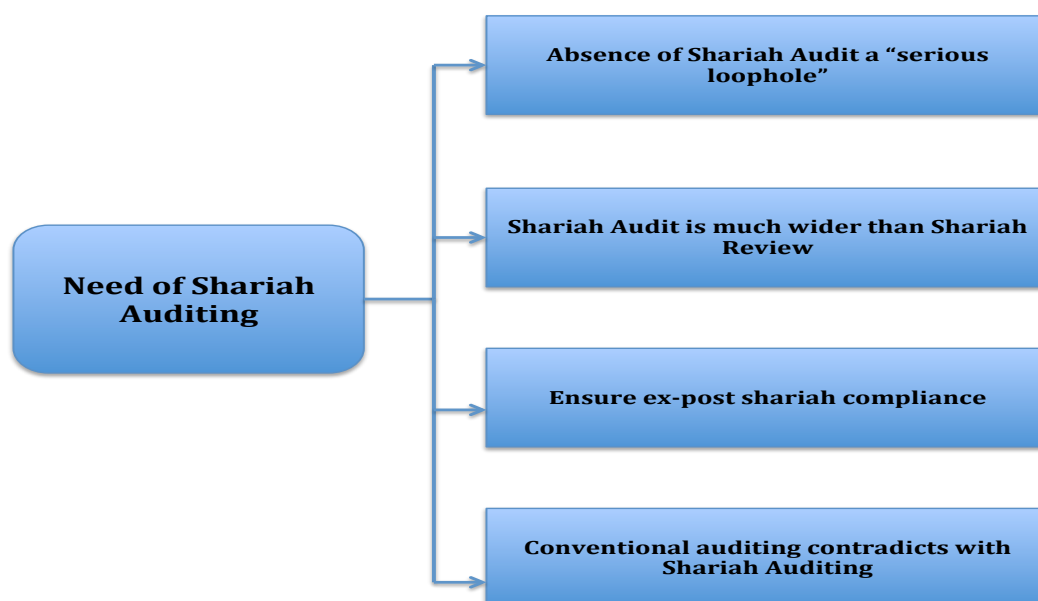


Figure 11-1: Need of shariah auditing in IFIs

## **11.2 Absence of Shariah Audit- a serious loophole of IFIs**

The absence of shariah audit is one of the bottlenecks of IFIs because Islamic finance is expected to grow more rapidly in near future. The current shariah review is carried out by Islamic banks in-house Shariah Supervisory Committee (SSC). But a thorough shariah audit should also scrutinized legal contracts, documentations and operations. As these things are not properly scrutinized by the SSC, there lies a functional gap between shariah audit and shariah review. The concept of shariah auditing is becoming a popular among the practitioners and in future there will be professional service firms who will conduct the shariah audit in different Islamic banks as external audit body.

## **11.3 Shariah review vs. shariah audit**

There are some similarities and dissimilarities between shariah review and shariah audit. While shariah review ensures only the ex-ante shariah compliance, shariah audit ensures both ex-ante and ex-post shariah compliance. The Islamic banks in house shariah supervisory committee carry out Shariah review. However, an independent professional body will conduct shariah audit. The work scope of shariah review is very limited. On the other hand, the scope of shariah audit is much more wider and broader than shariah review. While shariah review fail to examine every aspect of Islamic banking, shariah audit scrutiny legal contracts, documents and operations in every aspect of Islamic banking according to Islamic principles and shariah. Sharish review check only shariah related issues on all the before task transaction. However, shariah audit check a thorough and comprehensive audit after executing the contracts.



**Table 11-1: Comparison between shariah review and shariah audit**

<b>Shariah Review</b> (Current practice)	<b>Shariah Audit</b> (Proposed)
Ensure ex-ante shariah compliance.	Ensure both ex-ante and ex-post shariah compliance.
The members of SSC carry out shariah audit.	A new independent professional body will conduct shariah audit.
Limited scope of work.	Wider scope of work.
Fail to scrutiny every aspect of Islamic banking.	Scrutiny legal contracts, documentations and operations.
Check only shariah related issues on all the before task transactions.	Check a through and comprehensive shariah related issues on all after taks transactions.

#### **11.4 Demand of Shariah Audit: ensure ex-post shariah compliance**

We know that, there are two types of shariah compliance: (1) ex-ante shariah compliance and (2) ex-post shariah compliance. The ex-ante shariah compliance in Bangladeshi Islamic banks is basically the SSC's supervision, monitoring and controlling during the banks operation and after operation. This is done to ensure shariah compliance in the banks dealings and business. However, ex-post shariah compliance is very rare in Bangladesh. It requires a thorough and comprehensive audit to scrutiny the transactions of the bank after the execution of contracts. The ex-post shariah compliance is done following random sampling technique to ensure that the transactions follow shariah guidelines.

### **11.5 Necessity of shariah auditors**

Shariah audit is wider than shariah review as it also scrutinizes process, people and governance. As internal shariah reviewers have limited scope of work, shariah review fails to scrutiny every aspect of Islamic banking. However, a shariah auditor not only scrutinizes the accounting practices of an Islamic bank but also scrutinizes whether the bank is following the Islamic shariah precisely. So, the necessity of shariah auditor is:

1. Finding and reporting shariah compliance and non-compliance
2. Identifying the attributes of non-compliance and their effect of the banks whole performance
3. Recording corrective measures to the respective responsible persons.

### **11.6 Requirement of shariah audit: “Conventional Accounting” contradicts with “Islamic Accounting”**

In Bangladeshi Islamic banks there is an internal audit carried out by SSC and there is an external audit carried out by conventional professional auditors. The conventional auditors audit these banks following the conventional accounting and auditing rules, regulations, principles, standards and framework. The conventional (external) auditor does not ensure that the Islamic banks carry out their operation maintaining the shariah compliance. In order to ensure that, the Islamic banks are following shariah rules and regulations an external shariah auditing is necessary. This is because, conventional accounting concepts, principles and assumptions including historical cost price principle, matching principle, revenue recognition principle, the concept of objectivity, monetary unit, and the going concern assumption are contradicted with

Islamic Accounting model. For example, historical cost price principle and conservatism is confusing and cannot assure the fairness and morality of the transaction that is not accepted according to Islamic shariah. According to historical cost price principle transactions are recorded on the basis of acquisition price that reflects the understated value in the financial statements and not acceptable in Islamic finance. The matching principle is immaterial because, Islamic accounting supports the accountability through Zakat. In conventional accounting, going concern assumption means, the business organization will continue to operate for an indefinite period of time, also contradicts with Islamic accounting as this means there is something other than almighty Allah will live for an indefinite period of time. It is impossible for an external auditor without having solid knowledge on holy Qur'an and sunnah of prophet Muhammad (SM) to conduct audit in Islamic financial institutions. So, it is needed for an external shariah auditor to conduct shariah auditing in Islamic financial institutions according to Islamic rules, principles, fatwa and shariah.

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## Chapter-12: FINDINGS

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*This chapter explains the findings of the study through the information collected by close-ended questionnaire and analysis of the data.*

*It also puts light on the valuable information gathered from open-ended interviews with the respondents of the research.*

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There are 90 respondents in this research. Among them 30 were shariah scholars, 30 were auditing practitioners and 30 were accounting academicians. The issues covered by this research are- (1) Awareness of the term shariah audit. (2) The importance of establishing shariah audit as a separate discipline. (3) Need of shariah audit side-by-side shariah review (4) Cost-effectiveness of implementing shariah audit (5) Shariah audit and their appointers (6) Qualifications and skills of shariah auditors for Islamic banks (7) Scope of shariah audit (8) Procedure and schedule. (9) Independence of shariah auditors (10) Role of Islamic banks in promoting Islamic audit. The information was collected through personal interviews and questionnaire survey.

### **12.1 Research Question # 1**

What is “Shari’ah Audit” in Islamic Banks in Bangladesh? Should “Shari’ah Audit” be an important area to become a discipline?

#### **12.1.1 Awareness of Shariah audit**

Though Shariah audit has become an entertaining topic among the scholars of Islamic finance it is yet to be an attracting topic to accounting professional. Most of the respondents considered the definition of shariah review given by AAOIFI have appropriate. Though most of the respondents felt that shariah audit and conventional audit were different but many of them considered that the shariah audit framework is

quite similar to that of conventional audit. The respondents became aware of shariah audit from different sources like TV, radio, Internet, words of mouth. The respondents had varying experience of awareness about shariah audit. The present research found that 44.11 percent of the respondents are unaware of the term shariah audit.

#### **12.1.2 Why the respondents are unaware about the term shariah auditing?**

The internal auditors (SSC members) may have a sound knowledge on Islamic shariah and Islamic finance and at the same time they may have a good understanding on conventional accounting practices. But as an individual discipline shariah auditing has not evolved yet. As a result, though the members of SSC have a sound knowledge on Islamic finance, they do not have the proper understanding of the necessity of the shariah audit. On the other hand, conventional auditors and accounting academicians study the principles, guidelines and procedures of conventional auditing. They audit from a conventional point of perspective, not from shariah perspective. So, shariah audit as a separate branch is very necessary for the Islamic banks in Bangladesh to ensure strict shariah compliance in all their activities. Shariah auditing is not a separate discipline yet in Bangladesh. There is no subject in the universities and colleges as shariah auditing. As a result, people who work in Islamic banks and the people who study in the colleges and universities are unaware of the necessity of shariah auditing in Islamic banks.

#### **12.1.3 Shariah audit as a discipline**

The research found that the majority of the respondents believed that there should be a separate and individual discipline named as shariah audit.

## **12.2 Research Question #2**

Who should be the “Shari’ah Auditors” in Islamic Banks in Bangladesh and who should appoint them?

### **12.2.1 The shariah auditors**

According to most of the respondents shariah audit should be carried out by ‘Shariah Auditors’-professional trained and certified in shariah audit. However, a healthy percentage of the respondents also felt that internal auditors under the guidance of Shariah Supervisory Committee might carry out the shariah audit.

### **12.2.2 Qualification of Shariah Auditors**

About the qualification of auditors the research has got varied responses. The research found that the respondents felt the need of both accounting and shariah knowledge as the pre requisite to become shariah auditor. However, there was a slight variation about this knowledge accounting or shariah –is more important than other. Some placed accounting knowledge before shariah knowledge, some other placed shariah knowledge before accounting. However, everyone advocated a mixed knowledge of shariah and accounting.. While most of the audit practitioners and accounting academicians considered Degrees/Professional qualification in accounting and specialized certification in shariah audit as the minimum requirements, the shariah scholars opine that it should be Degree /professional qualification in accounting and Fiqh (Islamic Law).

### **12.2.3 Appointers of the shariah auditors**

The research found that shariah auditors should be appointed by Shariah Supervisory Committee on behalf of the Board of Directors of the respective Islamic banks.

However, a few respondents opined in favor of the shareholders of Annual General Meeting (AGM).

### **12.3 Research Question #3**

Which areas of Islamic Banks in Bangladesh “Shari’ah Audit” should cover?

#### **12.3.1 Scope of shariah Audit**

Shariah audit is a broader term than conventional audit. Because it does not only consider the financial statement it has to consider- (a) Business plans (b) Procedures (c) Agreements (d) Financial systems and reporting (e) HRM (f) Charities (g) Environmental effect of operations (h) Marketing (i) Public relations (j) Reports (k) Zakat computation and disbursement (l) Information Technology Application systems etc.

### **12.4 Research Question #4**

When and how should “Shari’ah Audit” be carried out in Islamic Banks in Bangladesh?

#### **12.4.1 Procedure of shariah audit**

As shariah compliance is a very broad area, the respondents give varied opinions. Majority of the shariah scholars considered checking every single transaction is the best way to ensure shariah compliance. Audit practitioners and accounting academicians gave almost equal importance on ‘as the auditor’s feels’ and ‘using existing sampling method’ as a better option while the later one getting slightly healthier importance.

#### **12.4.2 Timing of shariah audit**

The research found that the respondents were divided in opinions about the timing and procedure of shariah audit. Some respondents (shariah scholars) thought that shariah audit should be carried out all through the financial year while others (audit practitioners and accounting academicians) wanted to carry the shariah audit at the end of the financial year.

### **12.5 Research Question# 5**

Should the Shari'ah Auditors audit neutrally and impartially?

#### **12.5.1 Independence of the shariah auditor**

Almost every respondent opined that shariah auditors should be independent of the institution they audit. In order to conduct the shariah audit properly the shariah auditors should be independent of the institution they work for and there should be sufficient number shariah auditors in the Islamic banks shariah committees.

### **12.6 Research Question# 6**

Are the Islamic Banks in Bangladesh promoting shari'ah audit effectively?

#### **12.6.1 IT system and shariah Audit**

IT system may or may not provide the shariah auditors with the sufficient information for conducting shariah audit properly. So, it has to be used in a way so that it provides sufficient information.

#### **12.6.2 Role of Islamic bank in promoting shariah audit**

While the shariah scholars are quite satisfied with the effort of Islamic banks in promoting the shariah audit among the common people, accounting practitioners and accounting academicians and quite unhappy and quite negative about the role of



Islamic banks in promoting shariah audit. However, some accounting practitioners and accounting academicians feel neutral about the performance of the Islamic banks.

### **12.7 Research question#7**

Should “Shariah Audit” be carried out along with “Shariah Review” in the Islamic Banks in Bangladesh? Will Shariah Audit be cost-effective?

#### **12.7.1 Shariah audit along with shariah review**

Most of the respondents opined that there should be a proper shariah audit side-by-side shariah review in the Islamic banks in Bangladesh.

#### **12.7.2 Transaction and monitoring cost theory**

Accounting academicians and audit practitioners think that because of the involvement of huge transaction and monitoring costs, Islamic banks in Bangladesh are unwilling to carry out shariah audit instead of or along with shariah review. Shariah scholars think that hiring a professional shariah audit firm first and monitor them will lead huge transaction and monitoring costs. So Islamic banks are not willingly to do so right now.

#### **12.7.3 Agency problem**

In order to implement shariah audit, the stakeholders are ready to bear all transaction and monitoring costs by taking lesser profit from their investment. However, the bank management is feeling quite hesitating to do so. As a result principal-agent problem occurs.

#### **12.7.4 Residual Claimants**

Though it will increase initial transaction costs and monitoring costs, it will also ensure proper shari’ah compliance. Ultimately, the common clients (mass people) of

the islamic banks in Bangladesh will be ensured that these banks maintain all the shari'ah principles of Islam. They will have a bigger trust in these islamic banks which will result in an increase of the number of clients and business. As a result, these banks will earn a hefty profit in the long run.

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## Chapter-13: RECOMMENDATIONS

*This chapter includes the recommendations of the whole research.*

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1. **Shari'ah audit as a separate discipline:** In order to establish shariah audit as a separate discipline, a new curriculum has to be designed which will cover both accounting and shariah related topics. In our country Bangladesh, we have professional auditors who have sound knowledge in conventional accounting. We also have shariah scholars who have sound knowledge in Islamic shariah. However, a combination of accounting and shariah knowledge is very rare. To establish shariah audit knowledge in both accounting and shariah is required. To create workforce who are skilled in both accounting and shariah issues, shariah audit, as a separate discipline has to be established.
2. **Training on shariah auditors:** Shariah auditors must be trained on a lot of other issues along with normal economic activities. These should include: (a) Business policies (b) Process and procedures (c) Contracts and agreements (d) Financial systems and reporting (e) Human Resource Management (f) Social activities and contributions (g) Environmental impact of operations (h) Marketing (i) Public relations (j) Reports (k) Zakat computation and disbursement and (l) Information Technology Application systems etc.
3. **Appointers of shariah auditors:** There should be a separate and individual body for appointing shariah auditors in Islamic banks. Because shariah auditing is a very important tool for maintaining shariah compliance. This particular task has to be done precisely. If there is an individual body for appointing shariah auditors in different Islamic banks, it would ensure a

selection of skillful shariah auditors. This body will be able to appoint shariah auditors for a specific Islamic bank in consultation with the management of that bank.

4. **Independence of the shariah auditors:** To ensure proper shariah auditing in Islamic banks the shariah auditors should be completely independent in the institution they work for. At the same time the group of shariah auditors should have sufficient number of auditors in it so that it can scrutiny all the documents, transactions, policies and other necessary issues minutely.
5. **Promotional activities:** Islamic banks in Bangladesh should play in bigger role in promoting the shariah audit among the common people. If the people are assured of the shariah compliance maintained by the Islamic banks they will feel more attracted to these banks because more than 90 percent of the total population of this country are Muslim.
6. **Improving the reliability of Islamic banks:** Making the Islamic banking more reliable, three strategies have to be followed. (a) A unique set of standards for auditing Islamic banks and financial institutions following the Islamic shariah principles strictly have to be developed. (b) The improved management, policies of operations and recruitment in the Islamic banks and financial institutions must assure the general people of shariah compliance. (c) The existing Islamic banking and financial institutions should maintain a shariah compliance rating of the Islamic financial institutions and their product and services.
7. **A collaboration approach:** As shariah auditing is not mandatory yet by the Bangladesh Bank (Central bank), there is a need for external shariah auditors, internal auditors and shariah review department within the bank to work

closely with the Board of Directors to ensure shariah compliance in Islamic banks.

8. **Ensure both ex-ante and ex-post shariah compliance:** It is mandatory for all Islamic banks in Bangladesh to ensure both ex-ante and ex-post shariah compliance. Shariah review department of the respective Islamic bank maintains ex-ante shariah compliance. However, ex-post shariah compliance is very rare in Bangladesh. So, all Islamic banks in Bangladesh should ensure ex-post compliance through implementing shariah audit along with shariah review.
9. **Policy framework:** A policy framework should be constructed to carry out external and internal shariah audits for Islamic banks of Bangladesh. To do so, Bangladesh Bank, Islamic banks themselves and / or a dedicated independent institution should implement shariah audit process.
10. **Improvement of AAOIFI standards:** The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) should develop up-to-date standards on relevant audit procedures and improve its standards of audit report. To ensure these improvement AAOIFI must modified its GSIFI standards.
11. **Urgency of Shariah Audit:** The present research has found that shariah audit is required for Islamic banks in Bangladesh to ensure proper shariah compliance in all their activities.
12. **Accuracy of the transaction:** Shariah audit of the financial transactions ensures the accuracy of the transactions and compliance to shariah regulations. Existing international shariah standards can serve as guidelines.

**13. Issues to be scrutinized:** Shariah audit should scrutinize the policies and procedures of the transactions, contracts, operation procedures etc. of the banks.

**14. Human Resource issues:** Shariah audit should also examine the human resource structure of the bank to see that the bank is capable of ensuring shariah compliance. This includes the scrutiny of qualified workforce having sufficient knowledge on shariah.

**15. Competence of Shariah Auditor:** In order to carryout shariah audit the shariah auditors must have clear understanding of the business of the bank, terms and conditions of contracts following shariah principles. The shariah auditor should also have the proper skills for auditing and knowledge of the techniques used for auditing, to ensure shariah compliance.

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## Conclusion

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The shariah audit and compliances distinguishes an Islamic bank from a conventional bank. The recent boost up of Islamic Banking and Financial Institutions has broad forward the issue of shariah audit and compliance. But there is a vacuum of knowledgeable experts in this area. Not many scholars of Islamic shariah have the ability to carry out shariah audit and compliance. The people transacting with this Islamic banks need to be ensured that the Islamic banks are running their operations following the Islamic shariah properly. So the Islamic banks must establish internal and external shariah auditor to ensure that all activities, transactions, products, policies, rules and regulations and operation procedures follow Islamic principles and shariah precisely.

The respondents had varying experience of awareness about shariah auditing. However, most of the respondents opined that shariah auditing should be a separate discipline. While shariah scholars claimed that the internal auditor under the guidance of shariah supervisory committee should conduct shariah audit, other respondents opined that an independent professional body should conduct shariah audit. While the shariah scholars considered checking every single transaction should be the best way to ensure shariah compliance, others advocated for existing sampling method. While shariah scholars are quite satisfied, accounting academicians and audit practitioners are quite unhappy about the roles of Islamic banks in promoting shariah audit among the common people. However, most of the respondents opined that there should be a proper shariah audit side-by-side shariah review in the Islamic banks in Bangladesh. Almost all the respondents think that because of the involvement of huge transaction and monitoring costs, Islamic banks in Bangladesh are unwilling to carry out shariah audit instead of or along with shariah review.

A unique set of standards for auditing Islamic banks maintaining Islamic shariah principles has to be developed. The existing Islamic banks should maintain a shariah compliance rating for their products and services. As shariah audit is not yet mandatory by the central bank of Bangladesh, there is a need of external shariah auditors, internal auditors and shariah review department within the bank to work closely with the Board of Directors to ensure shariah compliance of the respective banks.

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## Appendix-1

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### Questionnaire about Shari'ah Auditing in Bangladeshi Islamic Banks

Dear Respondent

Ritsumeikan Asia Pacific University (APU), Japan wants your cooperation in pursuing a research study about “*Shari'ah Auditing in Bangladeshi Islamic Banks: Theory and Practice*”. There is a questionnaire with this letter which requires your opinion about different issues of Shari'ah Auditing in Bangladeshi Islamic banks. It would take about 10 minutes to complete and your cooperation will be a great contribution to this research. The information you provide will be strongly confidential and will be used only for research purpose. If you have any questions about the research or about the questionnaire, you are welcome to contact us at: [jahimd11@apu.ac.jp](mailto:jahimd11@apu.ac.jp) or +881 4312 3152 (cell).

Thank you very much for your cooperation.

Sincerely

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## Questionnaire

### **“Shari’ah Auditing” in Bangladeshi Islamic Banks: Theory and Practice**

Please answer the questions by putting a tick (✓) in the box you think most appropriate. Your individual responses will be confidential. Your honest responses are requested. Thank you!

#### **1. Demographic information**

1.1 Name: \_\_\_\_\_

1.2 Institution: \_\_\_\_\_

1.3 Category of the respondent:

- ☐ Shari’ah Scholar / Internal Auditor
- ☐ Audit Practitioners / External Auditor
- ☐ Accounting Academicians

#### **2. Awareness of the term “Shari’ah Audit”**

2.1 Are you aware of the term “Shari’ah Audit”?

- ☐ Yes
- ☐ No
- ☐ Not sure

2.3 Are you aware of the difference between Shari’ah Audit and Conventional Audit?

- ☐ Yes
- ☐ No
- ☐ Not sure

2.3 Is Shari'ah audit framework similar to that of conventional audit?

- ☐ Yes
- ☐ No
- ☐ Not sure

2.4 If the answer to the above question (2.3) is "Yes", how much similar is the framework of Shari'ah audit to that of conventional audit?

- ☐ Very similar
- ☐ Somewhat similar
- ☐ Not sure

2.5 If the answer to the above question (2.3) is "No", how much dissimilar is the framework of Shari'ah audit to that of conventional audit?

- ☐ Very dissimilar
- ☐ Somewhat dissimilar
- ☐ Not sure

2.6 Do you have basic knowledge and understanding of Shari'ah audit?

- ☐ Yes
- ☐ No
- ☐ Not sure

2.7. From which source have you heard about Shariah audit? (If necessary, you can select multiple answers)

- ☐ TV
- ☐ Radio
- ☐ Internet
- ☐ Words of mouth
- ☐ Others

☐ None

### **3. The importance of establishing “Shari’ah Audit” as a discipline**

3.1 Should “Shari’ah Audit” be a new discipline other than existing audit discipline?

(e.g. Financial audit, social audit etc)

☐ Yes

☐ No

☐ Not sure

3.2 According to Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the definition of “Shari’ah Review” is “An examination of the extent of IFIs compliance, in all its activities with the shariah”. Do you think this definition can be used for “Shari’ah Audit” in Islamic Financial Institutions (IFIs)?

☐ Yes

☐ No

☐ Not sure

### **4. Shari’ah Auditors and their appointers**

4.1 Who should carry out “Shari’ah Audit” in Islamic Banks?

a. Regular (Conventional) external auditor

☐ Yes

☐ No

☐ Not sure

b. Islamic Scholars (Ulama)

☐ Yes

☐ No

☐ Not sure



c. Internal auditors under the guidance of Shari’ah Supervisory Committee (SSC)

- ☐ Yes
- ☐ No
- ☐ Not sure

d. Shari’ah Supervisory Committee (SSC)

- ☐ Yes
- ☐ No
- ☐ Not sure

e. “Shari’ah Auditors” – Professionals trained and certified in “Shari’ah Audit”

- ☐ Yes
- ☐ No
- ☐ Not sure

4.2 Who should have the authority of appointing “Shari’ah Auditors” in Islamic Banks?

a. Shareholders of the respective Islamic Bank through its Annual General Meeting (AGM)

- ☐ Yes
- ☐ No
- ☐ Not sure

b. Bangladesh Bank (Central Bank)

- ☐ Yes
- ☐ No
- ☐ Not sure

c. Islamic Financial Service Board (IFSB)

- ☐ Yes
- ☐ No
- ☐ Not sure

d. A new regulatory and supervisory body for observing “Shari’ah Audit”

- ☐ Yes
- ☐ No
- ☐ Not sure

### **5. Qualifications and skills of a “Shari’ah Auditor” for Islamic Bank**

5.1 What should be the required (Minimum) qualification of the “Shari’ah Auditor”?

- ☐ Degree/ Professional in Accounting
- ☐ Degree/ professional in Accounting and Fiqh (Islamic law)
- ☐ Degree/ Professional qualification in Accounting and specialized certification in “Shari’ah Audit”

5.2 Shari’ah auditors should have specialized shari’ah certification qualification on Shari’ah Auditing.

- ☐ Strongly Agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly Disagree

5.3 Shari’ah auditors should be qualified in both Shari’ah and Accounting.

- ☐ Strongly Agree
- ☐ Agree
- ☐ Neutral

☐ Disagree

☐ Strongly Disagree

5.4 There should be a body for scrutinizing the qualification and competence for the appointment of the shari'ah auditors.

☐ Strongly Agree

☐ Agree

☐ Neutral

☐ Disagree

☐ Strongly Disagree

5.5 Shari'ah auditors should be adequately trained in banking and Finance.

☐ Strongly Agree

☐ Agree

☐ Neutral

☐ Disagree

☐ Strongly Disagree

5.6 Shari'ah auditors should be adequately trained in shari'ah audit related risks and issues

☐ Strongly Agree

☐ Agree

☐ Neutral

☐ Disagree

☐ Strongly Disagree

## **6. Scope of Shari'ah Audit**

6.1 Shari'ah audit covers broader areas than conventional audit.

☐ Strongly Agree

- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly Disagree

6.2 Shari'ah audit should be limited to financial statement audit.

- ☐ Strongly Agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly Disagree

6.3 Areas of Islamic Banks to be covered by “Shari'ah Audit” (You may identify multiple areas)

- ☐ Business policies
- ☐ Process and procedures
- ☐ Contracts and agreements
- ☐ Financial System and reporting
- ☐ Human Resource Management
- ☐ Social activities and contributions
- ☐ Environmental impact of operations
- ☐ Marketing and advertising
- ☐ Reports and circulars
- ☐ Zakat calculation and payment
- ☐ IT system

## **7. Procedure and schedule**

7.1 How should “Shari’ah Audit” be performed in Islamic banks?

- ☐ For every single transaction
- ☐ As the auditor feels
- ☐ Using existing sampling methods

7.2 When should “Shari’ah Audit” be performed in Islamic Banks?

- ☐ All through the financial year
- ☐ At the time of new product launching
- ☐ At the end of the financial year

7.2 The IT systems sufficiently provide the Shari’ah auditors with the necessary data and information to complete the audit.

- ☐ Strongly Agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly Disagree

## **8. Independence of Shariah auditors**

8.1 Shari’ah auditors should be independent of the organization they work for.

- ☐ Strongly Agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly Disagree

8.2 There are sufficient numbers of shari'ah auditors in Bangladeshi Islamic Banks' shari'ah committees.

- ☐ Strongly Agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly Disagree

## **9. Role of Islamic banks in promoting Islamic audit**

9.1 The Islamic Banks have done enough to promote shari'ah audit.

- ☐ Strongly Agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly Disagree

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**Thank you for your kind co-operation**