

## Shariah Audit in Islamic Financial Institutions (IFIs): A Literature Review

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### ARTICLE INFO

#### Article History:

Received: 22<sup>nd</sup> October 2019

Accepted: 27<sup>th</sup> November 2019

#### Keywords:

Audit, Shariah Audit,  
Shariah,  
Corporate Governance,  
IFIs.

#### JEL Classification:

M42  
M48  
G30

### ABSTRACT

**Purpose:** The objective of this paper is to conduct an extensive literature review on Shariah Audit practiced in Islamic Financial Institutions and finding the research gap in the existing literature.

**Methodology:** The study is based on secondary data. The theoretical framework used in this paper is the Islamic agency theory. Shariah Audit is such a tool that can mitigate the agency problem to a great extent and thereby can ensure good governance.

**Findings:** Shariah Audit provides higher level of assurance by following the rules and regulations of Islamic Shariah. Shariah is the overarching framework for Shariah Audit, which ensures all the activities of the Islamic Financial Institutions (IFIs) comply with Shariah. Where the conventional auditors have limited liability towards investors and creditors, Shariah Auditors have more accountability to all the stakeholders including Allah (SWT), as Muslims believe that their deeds are being watched by the Allah (Muraqabah concept). Thus, the Shariah Audit can ensure good governance. Although there are some challenges in the implementation of Shariah Audit, designing an appropriate Shariah governance framework can resolve the issues.

**Limitations:** The study is based on secondary data only. Primary data may provide more practical insight in the field studied here.

**Practical Implications:** The study can help the regulators to institutionalize this specialized field and to develop Shariah governance framework.

**Originality/Value:** This is the only study that summarizes all the previous literatures related to Shariah Audit including developing country perspective. The study has suggested the avenue for further research in this area.

## 1. Introduction

As the Islamic Institutions are increasing in an emerging number in Bangladesh, apart from conventional financial systems, the Shariah Financial systems are also been followed by many Islamic Financial Organizations (Din, 2018). Especially Islamic banks are emerging in Bangladesh, as the demographic, socio-economic, religious and

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psychological view towards the conventional banking system is mostly non-appropriate (Ahmed & Khatun, 2013). Sheikh & Siddiqui (2016) has stated, "To support the increasing demand of Islamic Banking in a strong Islamic Financing Framework is much needed to moderate and operate the banking, financial reporting and its proper inspection as per the Islamic Financial rules and regulations". According to Arabyan, (2019) institutions, which are involved in Islamic Banking or Islamic Financial Institution, should step forward to achieve the goals of the Islamic law. The Maq'asid Ash-Shariah and Shariah Auditing have a vital role to play in making the Islamic Financial law more impactful (Arwani, 2018).

Shariah Audit is a systematic process of objectively obtaining sufficient and appropriate audit evidence to provide an opinion whether the subject matter (i.e. financial statements) is complying with the Shariah laws and regulations (Mohamed Sultan, 2007). The Shariah Governance Framework (SGF) was introduced by Bank of Negara Malaysia in 2010. It has defined Shariah Audit as "periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for Shariah compliance" (BNM, 2011, p. 23). Shariah offers means (wasa'il) such as facilitating financial contracts, establishing values and standards and instituting social responsibility (Laldin and Furqani, 2013). Shariah follows the Quran and Sunnah as the guiding principle coming from Allah (SWT) and his Prophet Hazrat Mohammad (SM).

A framework for Shariah Audit must be developed to reach the actual objectives of Shariah subservience in IFIs that might help to serve the society at a large scale (Radzi, 2018). In conventional auditing the area and liability of the auditor are shorter than it is usually in Shariah Auditing because in usual auditing the auditor has liability only towards the clients and the owners (Rahman, 2014). But in Shariah Auditing, he is liable to ensure the financers as well as all the related party, society, law, order and Islamic rules and regulations (Khan, 2019). In order to fulfil his contract with integrity, biases and faithfully the auditor must have a clear knowledge about the Islamic Law and its practices (Atiqah and Rahma, 2018). If the Islamic accounting and the Islamic finance are governed and regulated well in our country through proper monitoring and a well-established framework then the Shariah regulated auditing can assure the general people about the relevance and the authenticity of financial reporting as per the Shariah law (Noordin & Kassim, 2019).

The main objective of auditing is to assure the related parties upholding their rights and ensure the financial information verifiability, integrity, relevance, timeliness and usefulness (Astuty, 2015). Shariah Audit can guide the Islamic banking and Islamic accounting towards the mass acceptability in our country where following the Islamic

laws and regulations trigger more people towards Islamic banking and financial institutions that follow proper Islamic Shariah (Isa, 2014). There are four particular issues of Shariah Auditing, which are



Figure 1. Issues of Shariah Audit, Source: (Khalid et al, 2018).

There is a conflict on whether the Shariah Audit should only be performed by the Shariah professional or the professionally trained internal auditors can undertake the responsibility of Shariah Audit (Noordin & Kassim, 2019). But it should be ensured that whether the internal auditors are really capable of doing the audit work under the rules of Shariah law and whether they are expert enough to ensure the integrity expected from Shariah Audit (Farooq & Tbeur, 2013).

According to Siraj Ud Din, (2018) the modern Islamic finance was first formulated in the 1970s with an arising problem that most of the auditors either have good accounting knowledge but lack of Shariah knowledge or good Shariah knowledge but less accounting knowledge. Farooq & Abdel Bari (2015) have stated that it is must to have expertise on both Shariah and accounting knowledge to perform a good Shariah Audit but as there is no combined education for them, the Shariah financing, accounting and auditing are hardly done in most of our financial companies. Shariah Auditors with good accounting knowledge are not generally found in most of our audit firms let alone in the internal auditor teams (Maswadeh, 2014). In order to perform proper Shariah Audit one must have good knowledge over English and Arabic language as well as accounting, finance, auditing and modern business so that if a situation arises where there are no specific instructions on how to handle that situation, the auditor can take decision based on their proper knowledge and maturity (Farooq & Alahkam, 2016).

In the economy of a developed country, the audit has to be more significant and specific as the market stability heavily rely on the result of an audit as auditor's recommendations are highly evaluated in terms of the decision-making process and depending on that result people take financial decisions (Khan, 2019). Bangladesh is such a country where there are different religions, cultures, values and ethics that have some direct effect on business investments. An audit system must follow the social rules and it must have the ability to fulfil all the expectations from mass businesspeople. Shariah Audit has all scope for preserving social and basic rights without changing the classical audit methods and without violating other religious norms (Sori, 2016).

The independence of Shariah Auditor must be precised in order to have fully unbiased results as it is a common practice that they will have to rely too much on the Shariah directions which sometimes may fail to gain the expected results of the owners or the management (Minhat & Dzolkarnaini, 2016). As the main objective of the Shariah Audit is to ensure the greater benefit for the people and be unbiased as possible, the auditors must have access required to conduct the audit; then the goal of the Shariah Audit will be achieved (Khalid et al, 2018).

In order to conduct the Shariah Audit, Shariah Governance Framework (SGF) is mandatory. Arabyan (2019) has stated that, there should have a proper framework for external audit because it is hard to verify whether all the transactions are done as per the Islamic financial law or keeping the norms of Al-Quran and Sunnah if the internal auditor or management fails to provide evidence. If the management or company wants to hide some unlawful transaction from the external auditor which is unethical and does not have any material effect on the financial report, the auditor will surely fail to fulfill the objectives of Shariah Audit (Hapsari, et al., 2016). A proper framework will assure the auditor's accessibility to all the needed documents of the company and the management will be bound to provide them with all the evidence an auditor requires (Farooq & Alahkam, 2016).

## **2. Research Background**

The Islamic financial industry has just expanded over the past few decades and Islamic banking and finance is one of the fastest growing economic sectors of the world. Compared to the conventional banking and finance, Shariah Audit is still in its early stage as most of the Islamic countries of the world are not in a situation to perform Islamic audit essentially (Noordin & Kassim, 2019).

According to Ahmed & Khatun, (2013) organizations like Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Research and Training Institute (IRTI), International Association of Islamic Economics (IAIE), Islamic

Cooperation for the development (ICD), Islamic Society for Institutional Economics (I-SIE), Institute of Islamic Banking and Insurance (IIBI) are specialized organizations for Islamic banking and Islamic auditing. These organisations have developed standards for Islamic financing throughout the world issuing hundreds of standards for Shariah accounting, auditing, international Islamic finance ethics and governance with the help of several central banks (Farooq & Abdel Bari, 2015). Financial institutions, regulatory bodies, audit and financial firms from forty-five countries making the Islamic Finance more centralized and widely accepted, according to the regular finance (Farooq & Alahkam, 2016). Din, (2018) has stated the main objective of these organizations is to make a worldwide-accepted standard for Islamic financing, accounting, auditing that becomes widely accepted without changing the main framework or guideline of finance for avoiding any kind of contradiction. As a result, people get interested in Islamic banking and financing in a large number and are not get nagged about the religious bindings (Astuty, 2015). As general perception towards auditor is to detect any fault, fraud, unethical object in the financial statement and make it more acceptable to the related parties as well as the mass people, Shariah Auditing gives more assurance as it follows the rules and regulations as par Al-Quran and Hadith (Sori, 2016).

Although the number of Islamic financial institutions is increasing across the world, Shariah Audit is still in the amateur stage in the developing countries like Bangladesh (Rahman, 2014). In Bangladesh, the number of full-fledged Islamic banks and Islamic banking divisions are increasing, but Shariah Audit is not still made mandatory. In this country Islamic Financial Institutions have Shariah Supervisory Council (SSC) which is not even mandated by the central bank. They conduct Shariah review guided by Shariah Supervisory Council (Abdullah and Rahman, 2017, Rahman 2014). In Pakistan, Shariah Audit is also in the initial stage and the central bank of Pakistan is providing training on this (Ahmad, 2017). Shariah governance practice is also voluntary in Islamic insurance industry of Bangladesh (Alam et al, 2019). As the developing economy is very emerging for Islamic financing, Shariah Audit will have a vital role to play in ensuring good governance for these institutions. Therefore, there is a need to study about this field and to find out the research gap in this area. This will help to institutionalize this subject as a discipline as well.

### **3. Theoretical Framework**

The framework used in this paper is the Islamic agency theory, which is related to Shariah governance. Traditional agency theory of corporate governance is quite different from that of Shariah governance (Al-Nasser Mohammed and Muhammed, 2017). Agency theory is concerned with the relationship of manager and shareholder where there exists agency conflict (Jensen and Meckling, 1976). The Shariah governance requires separate

framework to explain the relationship between agent and principal (Shamsuddin and Ismail, 2013). Agency theory in Shariah governance focuses on the compliance of Shariah rules, regulations in Shariah based contracts, and a sound Shariah governance is mandatory for the development of Islamic finance because it is better able to deal with the dynamicity of Shariah-based contracts (Hasan, 2009).

In some cases, agents may go beyond financial interest i.e. religious values. They focus more on ethical values rather than financial interest that is the main concern of traditional agency theory. This philosophy makes the agent more accountable in Shariah governance. Shariah Supervisory Board mostly applies the Shariah governance framework, which is in charge of that accountability (Abdullah and Muhammed, 2012). The proper functioning of this board depends on independence of board members' appointment, competence of the members, consistency in the judgement provided and confidentiality or disclosure of information (Graiss and Pellegrini, 2006).

Shariah framework varies from corporate governance framework from a number of viewpoints. Shariah framework does not allow any interest to charge; instead, it focuses on profit sharing investment contracts (Karim, 2001). Investment is treated differently in Shariah framework and it comprises a significant percentage of total asset in Islamic banks. Nevertheless, there is no representation of these investment holders in the board. This makes the agency problem more acute (Safieddine, 2009). Moreover, the financial condition of Islamic financial institutions requires additional items to incorporate in the financial statements, for example Zakat which is absent in Non-Islamic organizations (Abdullah and Muhammed, 2012).

Sultan et al. (2013) has suggested an alternative theory to explain the relationship between principal and agent in Islamic financial contract. He criticized the agency theory to fit the structure of Shariah framework. Under Shariah governance, agency problem is the non-compliance of Shariah where, traditional agency problem is limited to fixed agency cost.

As the traditional agency theory has many limitations to fit in the Islamic structure, this study has focused on Shariah or Islamic agency theory where Shariah agent will be guided by the Shariah rules and regulation having utmost accountability to the Almighty. Shariah agent will apply the best practices to satisfy the best interest of all the stakeholders. In case of Shariah Audit, Shariah Auditor will serve as Shariah agent who will ensure that all the activities of Islamic finance comply with Shariah. As a result, it will reduce the agency problem and agency cost of Islamic financial institutions.

#### **4. Research Methodology**

The study has been conducted based on the secondary information. The information includes objectives of Shariah Auditing, Shariah laws and regulations, qualifications of

the auditor, scope of Shariah Auditing. The main secondary sources of information are Al-Hadith, Al-Quran, published articles and paper and textbooks on the related topics. The collected information was processed manually. This information was analysed critically and also in an analytical manner in order to make the study informative and valuable to the readers. The study has used the Shariah agency theory as the theoretical framework. Shariah Audit serves as a controlling mechanism that will help to reduce the agency conflict and agency cost (Jensen and Meckling, 1976). Thus, it will reduce the agency problem and will work for ensuring good governance.

### **5. Objectives of Shariah Audit**

The key objective of Shariah Audit is to provide periodical assessment and to add value and improve the degree of the audit assurance and make people believe that the Islamic institutions are following all the Shariah financing standards (Ahmed, 2015). The main objectives are summarized below:

- To know the company's current situation and to check whether they are following Shariah rules and regulations according to the framework.
- To examine the procedure of financial statement preparation.
- To re-check if the transactions are Shariah permitted, lawful and not done by any means of contradicting Islamic aspects morally or socially.
- To assure mass people that they are doing business as per Islamic Shariah and people can trust them with their money and do business especially to those who have problems with the norms of conventional banking or financing and stays away from them (Mokhha & Mokina, 2018).

In summary, Shariah Audit provides higher level of assurance that makes Islamic finance more acceptable and trustworthy to the mass people and the stakeholders (Farooq & Tbeur, 2013).

### **6. Significance of Shariah Audit**

Kasim et al. (2009) first studied the necessity for Shariah Audit. Ensuring the clean and effective Internal control system for Shariah consent is the main objective of Shariah Audit or any type of auditing, with the compliance relation with Islamic Financial Institutions laws and regulations an independent and periodical assessment is needed to assure value and reliability (Khalid, et al, 2018). As the institutions that follow the Islamic laws and regulations are the users of Shariah Audit by which they assure the integrity and cleanness of their internal financial situation and the expectations of the public that they are doing business as per Shariah law (Radzi, 2018).

According to Sheikh & Siddiqui, (2016) Bangladesh is one of the Muslim countries who realises the importance of mass investors to invest in the capital market who are lagging behind because of the absence of Shariah permitted law which is a matter of anxiety. Khalid et al, (2017) have suggested that in order to assure the major proportion of the public, the business, and institutions, financing and accounting activities should be conducted as per the Shariah permitted way. Shariah Audit will ensure that the institutions are following those rules and regulations (Mursid, 2018).

Rahman, (2014) has reviewed that the general perception of auditing in Islam is to inspect and judge the general operations through monitoring and reviewing the internal control reporting system of the transactions and cross-checking all the financial reports whether they are being made and controlled as per the Shariah permitted rules and guidelines in order to provide a fair, useful, trustworthy perception and justification for making right decisions.

### **7. The Characteristics of Shariah Audit**

It mainly focuses on the norms like Allah is the one and only owner of everything with the belief that we all are accountable for our works only to Allah and with that perception, everything has to be fair, clean and done with so much integrity (Siraj ud Din, 2018). According to Isa, (2014) Allah fearing morals lead to honesty, cooperation, trust, integrity, avoiding worldly greed, selfishness which results in following Quran and Sunnah guided paths and principals which is perfect, unbiased, magnificent, everlasting and trustworthy as audit as per Islam only follows ethical transactions avoiding all kinds of unethical means. Islamic audit does not only focus on material welfare and wellbeing but it also supports to keep in mind the spiritual aspects, which are applicable for both professional and personal life (Mursid, 2018).

The Islamic Auditing Foundation (IAF) has set a framework and specific guidelines for Islamic auditing to maintain the standards, which ensure the rights of public, prevents unethical aspects and guides the auditors to Shariah permitted norms (Farooq & Abdel Bari, 2015). The framework helps to evaluate the general standards to Shariah permitted standards without any kind of contradiction (Astuty, 2015). The rightful payment of the auditors and their work range and accessibility are specified by IAF in order to ensure the standard of the work (Farooq & Alahkam, 2016).

In Islam, an auditor is known as Muhtasib who must have academic, professional and Shariah knowledge about business, accounting and finance (Мокина & Мокина, 2018). According to Arwani, (2018) their main aim is to fulfil the contract they have been assigned with proper integrity under the rules of Islamic rules and practices keeping in mind the Islamic society perspective as they are liable to the company, clients, related

parties as well as the almighty Allah. Islamic audit always keeps in mind the society and community well-being that is why it believes in full disclosures with needed information as per the demand and need parallel with Shariah which never permits to hide any material information which might affect the decision making and may cause any deprivation (Waemustafa, 2015).

### **8. Regulators of Shariah Audit**

Ahmed & Khatun (2013) have stated, "Islamic Financial Services Board (IFSB) and the AAOIFI are the organizations that set Islamic finance standards independently who agree that the Islamic financing institutions need more specific governance and both the organizations have published accounting, reporting and auditing standards on corporate governance".

The IFSB prescribed principles on IFI's Corporate Governance recommends that not a single particular model can be applied to all Islamic Financial institutions globally (Sori, 2016). So, the framework will depend a lot on the specification of the particular IFI's (Ahmed, 2015). For an effective and sound guideline every IFI's size, risk profile, economic significance, structure, complexity should be considered proportionately (Khalid, et al, 2018).

According to AAOIFI, the main objective of Shariah Auditing is to get assurance for financial documents about whether they are prepared according to all material aspect with the consent of Shariah permitted rules, guidelines, fatwas, national and international accounting standards and practices and relevant regulations and legislation under the recommendations of Supervisory board (Radzi, 2018). The AAOIFI also recommend that the Shariah Auditors must have a professional code of conducts like righteousness, integrity, trustworthiness, fairness, honesty, independence, objectivity etc. (Farooq & Alahkam, 2016).

The Shariah Audit engagement is an agreement between auditee and the auditor which confirms the auditor's acceptance of appointment, his objective, the extent of his work, his accessibility, proper responsibility (Khan, 2019). In order to make auditors' report more credible, the auditor must review all the necessary documents, evidence, analyze them and then draw a conclusion that contains his opinion (Мокина & Мокина, 2018).

### **9. The Requirements for Shariah Audit**

In order to conduct Shariah Audit, there is a need to apply judgement by the auditors. Due to the diversity and the complexity of business and its transactions, Shariah governance might not have exact instructions about every situation or every type of

situation. The auditor has to rely a lot on his knowledge, experience, presence of professional mind in order to secure the Shariah Audit rules especially in an Unpredictable economy (Khalid, et al, 2017). According to Rahman, (2014) self-regulatory professional association can be created by Shariah Supervisory Board to issue Fatwa's maintaining standard contracts and practices. For ensuring adequate and consistent interpretation, a framework with internal and external features should be made if there is limited availability of Shariah jurisdiction (Noordin & Kassim, 2019).

Isa (2014) has stated that, to conduct the Shariah Audit, the internal auditors must be trustworthy and must have knowledge about Shariah. He has also urged the importance on the collaboration of internal and external auditors to have honest opinion and the enthusiasm of the internal auditors and management to fully comply with Islamic Financial guideline. Shariah Supervisory Board members are expected to have basic knowledge about Shariah law and proper auditing (Farooq & Tbeur, 2013). It is not the auditor's duty to prevent fraud, theft, errors, but the auditor will be responsible for these if these happen due to his negligence (Abubakar, 2016).

#### **10. Standards and Principles of Shariah Audit**

Norms, policies, practices provided by the authorities of Shariah Audit are considered to be the standard of Shariah Auditing and for generalizing them a constant framework is needed to make the Shariah standards widely acceptable (Khalid, et al, 2018). Sheikh and Siddiqui (2016) have stated that, the currently practiced audit methodology and norms were developed on the basis of the socio-economic culture of western countries and environment but to achieve legitimate objectives Islamic organizations established and followed Shariah-based norms for working in a different situation. According to Siraj ud Din, (2018) Islamic organizations uses various financial instruments and some of the transactions that are not well known to the western world.

The development of Shariah Auditing standard for Islamic Financial Institutions has been done from the feeling of necessity (Farooq & Abdel Bari, 2015). The main objective of these standards is to spread the Islamic auditing and accounting thoughts to Islamic institutions via training, seminar, publication, special education etc. Islamic Financial Institutions will prepare, promulgate, review and amend the accounting and auditing standards for their own purpose from the generalized standard (Astuty, 2015). The basic principles for Islamic auditing are integrity, objectivity, confidentiality, neutrality, continuity, planning, and legality, committed to ethics and committed to religion (Rahman, 2014).

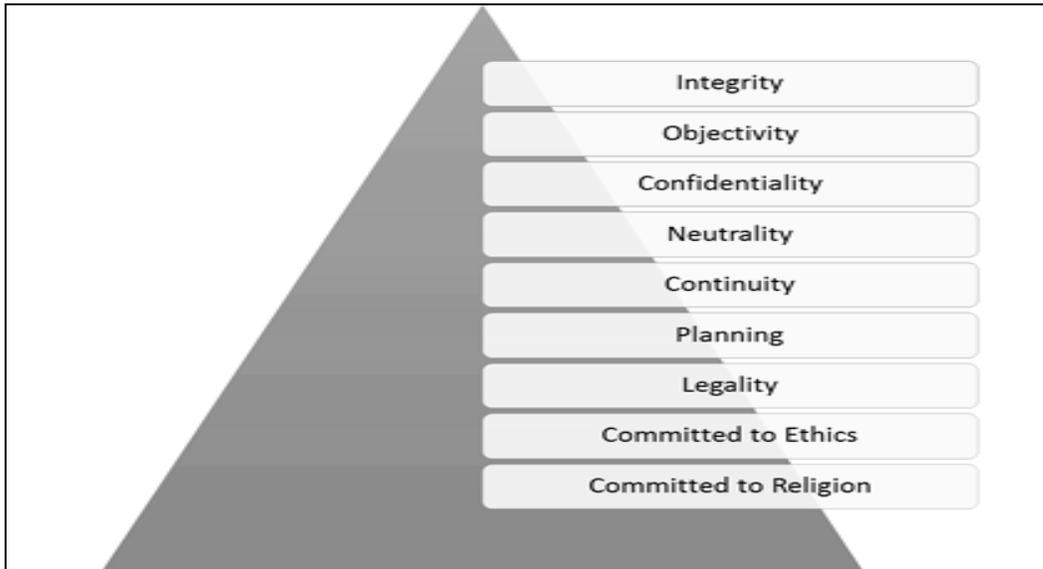


Figure 2. Basic principles for Islamic auditing. Source: (Rahman, 2014)

Islamic Shariah is the utmost standard for Shariah Audit. The sources of Islamic Shariah are the Quran and Sunnah. However, while designing the formal auditing standards for Islamic Financial Institutions, following generalized standards should be taken into considerations

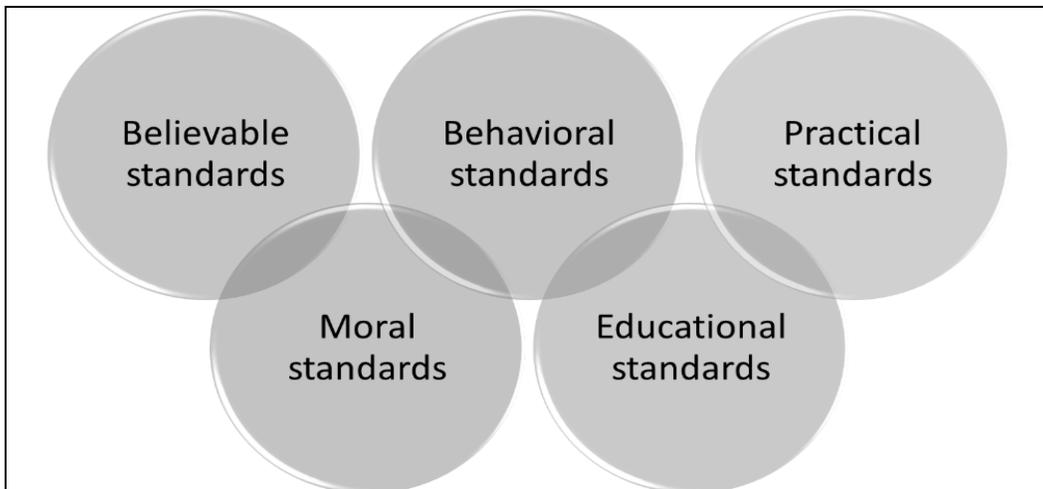


Figure 3. Auditing Standards. Source: (Arabyan, 2019)

**11. Roles and Resonsibilities of a Shariah Auditor**

In the Islamic framework, the liability of the auditors apart from the financers is increased according to the situation and rules of the particular economy, for example-

interest-bearing instruments are not permitted in Islamic finance (Radzi, 2018). All financing is done in the form of Mudarabah capital (equity capital) for different maturities (Arwani, 2018). The providers of capital from outside of the organization need an independent assurance about the profit or loss announced by the management on the basis of Mudarabah (profit or loss sharing) (Noordin & Kassim, 2019).

If this kind of audit assurance is not available it would be highly risky for the outsiders to invest their money which would make interest free financing almost impossible (Isa, 2014). In regular audit, service predetermined interest rates save the outside investors interest as the auditor counts profit or loss after repaying all interests as it is the foremost obligation but when there is no existence of interest, it is crucial to determine the profit or loss from outside (Farooq & Alahkam, 2016).

The profit depends on a number of decisions like depreciation rates on different assets, stock valuation policies, intangible assets amortization, charging to deferred payments to current operational income, apportionment of profit into reserves and dividends, etc. (Ahmed & Khatun, 2013). In classical audit framework, these things are being taken care by the management and auditors just recheck and examine them but in terms of Islamic audit standards may have to be revised for the determination of profit or loss for different categories of trade and industry (Khalid, et al, 2017).

Due care would be taken to arrive at a judicious and consistent figure of profit (or loss) so that the interest of outside financier is also protected (Khan, 2019). If there is no predetermined fixed interest rate, the financiers would fall into huge uncertainty for the announcement of profit or loss (Waemustafa, 2015). The morality and integrity standards in Muslim countries suggest that the auditor may have to go for an extended work to verify an actual figure of profit (or loss), without any formal obligation by management, just for the benefit and well-being of the financiers (Abubakar, 2016).

It would be a third-party opinion on the business organizations operations (Ahmed, 2015). If the Islamic framework does not provide for such a role of the auditor, it would fail to fetch the necessary confidence and support of the masses (Farooq & AbdelBari, 2015).

## **12. Qualities of a Shariah Auditor**

The auditor must obey the “Code of Ethics for Professional Accounts” issued by Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) and the International Federation of Account which does not violate Islamic rules and principles (Sheikh & Siddiqui, 2016). The ethical principles governing the auditor’s professional responsibilities must have virtues like- Righteousness, Trustworthiness,

professional behavior, fairness, proficiency and efficiency (Ihsan), Sincerity (Iklas), Passion for Excellence, Professional Competence, Honesty, confidentiality (Arabyan, 2019). Ihsan means doing marginally more than the minimal requirements. Islam urges Muslims to do their jobs without any lapse or omission and to the best of their efficiency and competence. These humanitarian characteristics help an auditor to conduct the assurance service more effectively, as these characteristics are guided by the Quran and Sunnah (Farooq & Alahkam, 2016).

### **13. Shariah Audit and Good Governance**

Shariah Audit is mainly conducted in the organizations that follow and are operated according to Islamic Shariah rules (Khalid, et al, 2017). As the Islamic financial organizations claim that they conduct every step of their business as per Shariah rules and regulations that's why they are safer than the organizations that follow conventional banking or financing system (Arwani, 2018). However, there might be some issues that management would want to happen that might be contradictory to the Shariah law but are helpful for the betterment of the organization (Rahman, 2014).

According to Khan, (2019) this type of conflict of interest cause agency problem and to mitigate them the audit assurance services arise. The auditors check every bit of the accounting books, evidence, and financial statement to check every transactions and operations are conducted as per Shariah regulation (Noordin & Kassim, 2019). In an Islamic organization there is a Shariah Regulatory Committee who fixes the operational activity, the working range and work procedures as per the internationally accepted Shariah law (Farooq & Tbeur, 2013). If any problem occurs that does not have any specified solutions in the rules, they take actions with mutual understanding within the committee (Minhat & Dzolkarnaini, 2016). So Shariah Audit is also for ensuring the uses of corporate governance and to reduce the agency costs and it helps to uphold the ethics of Islamic Shariah and secures the belief of mass Muslim people (Isa, 2014).

Bank Negara Malaysia has developed Shariah governance framework that is widely accepted and followed by most of the Islamic Financial Institutions. There has to be a Shariah committee that is accountable to purify any mistakes or confusions in terms of audit related matters and who are bound to explain everything to the board. Every Islamic Financial institutions are urged to appoint a committee with expert person on Shariah related affair and are suggested to communicate with the Board of Directors about each and everything (Alahkam, 2016).

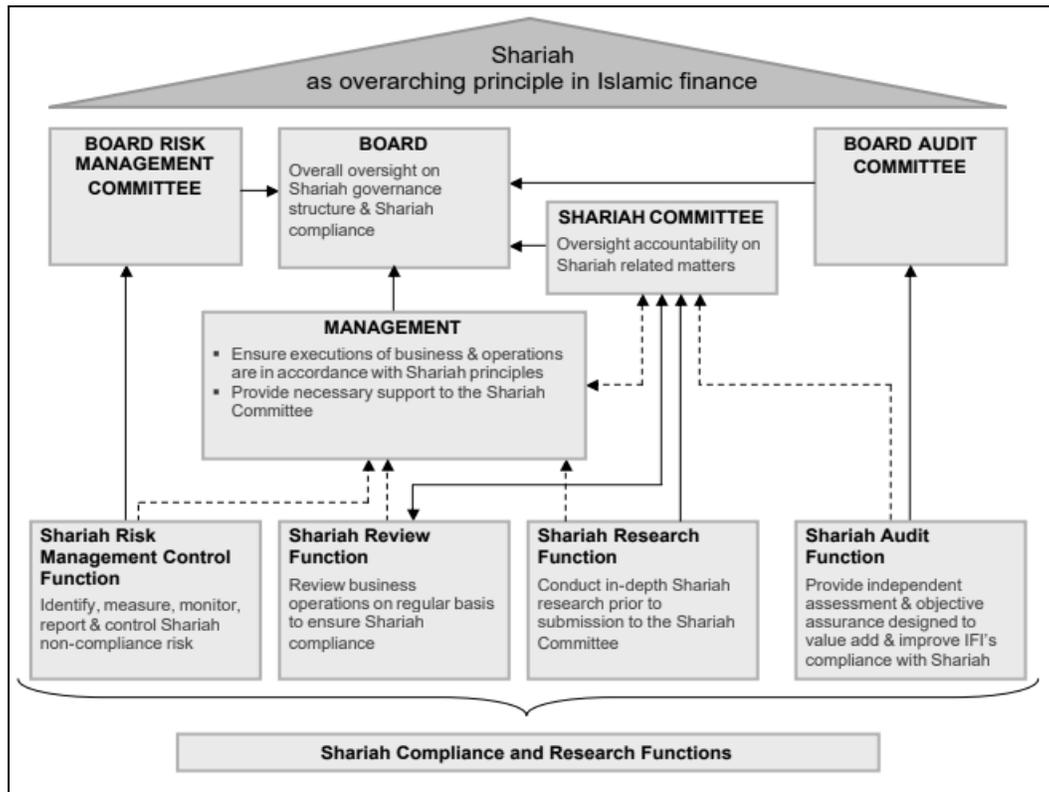


Figure 4. Shariah Governance Framework for IFI. Source: BNM 2011, p.8

The Shariah Governance Framework is developed by Bank Negara Malaysia in 2011 and it suggests to establish four Shariah functions: Shariah risk management function, Shariah review function, Shariah research function and Shariah Audit function. Shariah Risk Management Control Function performs as a supervisor of both the management and Board Risk Management Committee as well. Basically undergraduate Finance and Shariah officers perform Shariah Risk Function. Shariah committee and Management administrates the Shariah Review Function. The Shariah Audit Function is administrated by the Shariah Committee and they also reports to the Board Audit Committee. The Shariah research function is conducted by the officers who are Shariah undergraduates in their respective Islamic Banks. Out of these four functions, Shariah Audit ensures that all the activities of the Islamic Fiancial Institutions are conducted with high level of complcance with Shariah. Shariah Auditors feel more accountability to all the stakeholders such as investors, credoitors, lenders, rugulators, government, general public and most impotantly to Allah (SWT). “..... Surely Allah will take account of all things” (Al-Quran, Al Nisa’: 86). The fear of Allah will make the Shariah Auditors more accountable. Thus the shaiah audit will serve as good controlling mechanism which will

reduce the agency problem to greater extent. Thus Shariah Audit ensures good governance.

Shariah Audit serves more than assurance of financial statements, internal control system and governance (Yahya Y., 2018). Bt, Noor & Abdullah et al, (2019) has proved that Shariah Audit as part of Shariah governance framework plays an important role in ensuring sound internal control system in takaful industry in Malaysia. Internal Shariah Audit has contributed a lot in the takaful sector, and it should be strengthened more to better take care of Islami banking asset and takaful contribution (Zakaria, Ariffin & Zainal, 2019). Shariah committee has a great contribution in ensuring good governance in IFIs. Banks having higher frequency of Shariah committee meeting have lower Shariah non-compliance risks (Basiruddin, R. and Ahmed, H., 2019). When the Shariah compliance is integrated with the information system of IFIs, it serves as a competitive advantage for the IFIs (Ayedh et al, 2019).

#### **14. Problems of Conducting Shariah Audit**

The operations of IFIs are unique and it is difficult to implement Shariah Audit (Shahar, Hassin and Zan, 2018). The major problem in conducting Shariah Audit is the requirement of human capital and this was studied by Laldin (2012) who focused on the generation of talented and expert human capital for offering Shariah based services. The success of audit will be affected due to the lack of Shariah experts; therefore, there is need for human resources having specialized knowledge and training on Shariah (Shafii, et al. 2013; PwC, 2011). There are not enough institutions to provide proper training on both auditing and Shariah law (Rahman, 2014). As management and Shariah Audit council have too much effect on auditors, the Islamic banks do not consider that the external auditors are fully independent (Astuty, 2015). If the companies are not fully enthusiastic about maintaining the main objective of Shariah Audit, they will not provide enough evidence or account books to the auditor, then it will be hard for the auditor to conduct Shariah Audit properly (Waemustafa, 2015).

The auditor must have to go through all the documents available and then give an independent opinion but if the auditor is not free from biases or lack primary knowledge of Shariah guidelines or audit methods, the auditor's opinion will not be fully effective (Abubakar, 2016). If the management of the bank does not believe in the purity of transactions, the customers will not keep faith on Islamic financing and banking (Shafii et al., 2014). Shariah Compliance and regulation for Islamic finance are still not properly standardized in Bangladesh as the Shariah Auditing practice is hardly be seen in any banks or financial institutions other than Islami Bank Bangladesh (Siraj ud Din, 2018).

The lack of knowledge about the Shariah governance, guideline, Quran and Sunnah lead the auditors to provide less reliable report (Ahmed, 2015). It has been found that the

accounting system and its procedures are not fully in compliance with Islamic Shariah because of a scarcity of knowledge of accounting personnel in this field (Hapsari, et al., 2016). Therefore, there is a need to provide adequate training to develop experts on Shariah Audit.

### **15. Shariah Audit in Bangladesh**

Bangladesh is a developing country with more than 90% Muslim community. There are eight full-fledged Islamic banks in Bangladesh and most of the conventional banks have Islamic banking window. Besides there are some Islamic institutions who prepare financial statements, according to Islamic Shariah laws and regulations (Sheikh and Siddiqui, 2016). They are mostly Islamic insurance companies. Siraj ud Din, (2018) has stated that, some other commercial banks have also started Islamic banking segment in along with conventional banking. So, the concept of Islamic banking has got enough recognition in Bangladesh as it is a Muslim populated country and the religion has some disagreement on the issues of interest in banking business and services (Ahmed & Khatun, 2013).

Although Bangladesh has many Islamic financial institutions, Shariah Audit is not made mandatory by the regulators of the country. The central bank has issued guideline for establishing full-fledged Islami bank and operating Islamic banking divisions. In order to ensure Shariah compliance, Bangladeshi Islamic financial institutions follow internal Shariah review supervised by Shariah Supervisory Council (SSC). But it does not follow the comprehensive approach to test the transactions and Shariah based contracts resulting in significant deviation from Shariah Audit (Rahman, 2014).

Shariah governance framework in Bangladesh is mostly voluntary in nature. The Shariah supervisory committee is voluntarily created by the Islamic banks of Bangladesh. This council operates under the conventional board of directors that is in charge of ensuring Shariah compliance of the bank. The Islamic banks of Bangladesh have voluntarily established the Central Shariah Board for Islamic Banks of Bangladesh (CSBIB) that is not even recognized by the central bank. Islamic banks need to conduct conventional audit mandatorily in addition to Shariah review. This is a treat for the banks and increases the agency cost of the banks. Therefore, there is a need for separate Shariah governance framework for Islamic financial institutions of Bangladesh (Abdullah and Rahman, 2017).

The Muslims of Bangladesh are very keen to keep their accounts with Islamic banks as interest is prohibited for Muslims. Islamic banks or Islamic financial institutes convince Muslims to invest or to take services of those Islamic institutes as they are operating obeying the rules and instructions of the Almighty Allah (Radzi, 2018). It is also essential for the Islamic organizations to conduct the Shariah Audit as per the Shariah

laws and regulations in order to gain the faith of the mass Muslim people and give them assurance that they are following every rule of Shariah financial law (Khalid, et al, 2017).

The compliance of Shariah governance in Bangladesh is in vulnerable state (Ullah, 2014). According to Arabyan, (2019) it is not a common practice in our country to conduct special Shariah Audit instead of conventional audit. The Shariah Audit requires experts who have specialized knowledge about both the Shariah law and conventional accounting rules and audit procedure to give the audit and assurance service properly. Nevertheless, the fact is that Bangladesh lacks Shariah scholars to conduct Shariah Audit. Moreover, lack of Shariah framework hinders the development of Shariah Audit in the country. Training on Shariah issues is hardly offered in Bangladesh except Islami bank Bangladesh Ltd. (Rahman, 2014). So that is why Shariah Auditing is not as widespread in Bangladesh as much it is in countries like Malaysia, Pakistan, Dubai (Farooq & Abdel Bari, 2015). It requires lots of investment and government support to make more auditors capable of conducting Shariah Audit and make the Islamic institutions and banks to conduct Shariah Audit externally for making sure the integrity of those companies to mass people (Astuty, 2015).

## **16. Future Research**

Though there has been a lot of research done on Shariah Audit worldwide, a very few researches are done on the practice aspects on Shariah Audit. Due to the limitations of data, time and scope, this study has been conducted on a very small scale based on secondary data. Primary data related to Shariah Auditing may reveal more avenue for research in this area. In developing country, Shariah Audit is just a new term let alone the application. Research on the significance of Shariah Audit or whether Shariah Audit is superior to conventional audit may attract the Islamic financial institutions to adopt Shariah Audit. It can also communicate the policy implications of Shariah Audit to the regulators and policy makers. Moreover, expert opinion from Shariah Auditor, Shariah scholars, regulators, government can add more value to the study in this area. Why the Muslim countries have not yet adopted the Shariah Audit can be an interesting topic to study. Where the Shariah Audit is practiced (except Malaysia), to what extent it complies with the Shariah or what are the problems of implementing the Shariah Audit can bring more practical insight to light. There are lots of scope vacant for research in the development of Shariah Audit standard and Shariah governance framework as well.

## **17. Conclusion and Recommendations**

The study has focused on the literature of Shariah Audit in Islamic Financial Institutions (IFIs) covering the broad areas of definition of Shariah Audit, its significance, Shariah Auditors qualifications and standards, problems and prospects of Shariah Audit, Shariah agency theory and practices in the developing countries. In Muslim countries, Islamic

banking or financing is very crucial as there are large number of people who stay out of conventional banking or financing activities as there is some contradiction with the religious point of view (Waemustafa, 2015). Islamic banking and financing are helping them to contribute to the economy and Shariah Audit is ensuring them that their norms, beliefs are being equally respected and protected (Hapsari, et al., 2016). With the increasing need and demand of Islamic banking and financing, Shariah Auditing should also be focused more and more so that the Islamic financial organizations are forced to maintain their accounting and financial reporting with the guideline of Shariah law, Quran and Sunnah. For that, a standardized framework should be developed, and proper training and education opportunity should be provided to make more and more qualified Shariah Auditors (Shafii et al., 2014). And more and more qualified and expert Shariah Auditors will try to address the Shariah agency problem in a better way and will contribute toward the development of good governance in the Islamic Financial Institutions. An all-out effort should be coming from regulators, government, Shariah scholars and above all Muslims community to take this topic further ahead.

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