

SHARĪ'AH AUDIT FOR ISLAMIC BANKS: A
COMPARATIVE STUDY BETWEEN BANK ISLAM
MALAYSIA BERHAD AND ISLAMI BANK
BANGLADESH LIMITED

BY

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ABSTRACT

Nowadays, *Shari'ah* auditing has become a significant topic in line with the advanced development of the Islamic Financial Institutions (IFIs). To implement the *Shari'ah* audit, Bank Islam Malaysia Berhad (BIMB) follows the “*Shari'ah* Governance Framework” which is mostly monitored by the *Shari'ah* Committee, whereas Islami Bank Bangladesh Limited (IBBL) follows “Internal *Shari'ah* Review” process in the bank’s dealings. However, internal *Shari'ah* review does not cover a comprehensive audit process to examine the transactions after the execution of the contracts. Therefore, an analytical comparative study for a standard framework of *Shari'ah* audit is essential for the current practices. This research focuses on the current practice of *Shari'ah* audit of BIMB and IBBL. The main objective of this research is to discuss the relevant issues of *Shari'ah* audit and to evaluate the scope by examining the current practices of *Shari'ah* audit at BIMB and IBBL. This research adopts a qualitative approach throughout the study. Therefore, it has been accomplished by utilizing the analytical and descriptive method to discuss the theoretical issues of *Shari'ah* audit along with empirical method through a semi-structured interview with Islamic banking practitioners and *Shari'ah* scholars. It also follows a comparative method to analyse the data. This research comprises seven chapters along with the conclusion. The first chapter has dealt with the outline and the proposal of the research, followed by the second chapter in which the theoretical and conceptual framework of the *Shari'ah* audit is discussed. The third chapter allocated with issues, scope, and challenges of *Shari'ah* audit. The subsequent chapters have comprised the brief outline of Islamic banking and finance in Malaysia and Bangladesh along with the current practices, functions, and challenges of *Shari'ah* audit. The research found that the practice of *Shari'ah* audit is an important tool that enhances the integrity and prompt development for BIMB and IBBL. It also found that both banks used the term “*Shari'ah* compliance” to imply a broader understanding, responsibility, and accountability by checking and assuring that every single activity of both banks is in compliance with the *Shari'ah*, while they used the term “*Shari'ah* audit” to refer to the periodical assessment. The research indicated that the concept of *Shari'ah* compliance audit is much wider than other scopes and issues of Islamic banking practices that cover both ex-ante and ex-post *Shari'ah* compliance audits. Nevertheless, the study showed that *Shari'ah* audit in both banks are being developed based on their capacity. However, BIMB’s legal and *Shari'ah* governance framework is more comprehensive than IBBL. In a nutshell, the researcher finds that this study has succeeded in analyzing the current practices of *Shari'ah* audit in BIMB in Malaysia and IBBL in Bangladesh. Finally, the research has provided some recommendations to the management of BIMB and IBBL as well as to the *Shari'ah* committee and practitioners in Malaysia and Bangladesh on the *Shari'ah* audit.

خلاصة البحث

أصبح التدقيق الشرعي موضوعًا مهمًا يتمشى مع التطور المتقدم للمؤسسات المالية الإسلامية (IFIs)، ولتطبيقه. يتبع بنك إسلام ماليزيا بيرهاد (BIMB) "إطار الحوكمة الشرعية" الذي تراقبه اللجنة الشرعية مراجعةً سابقةً للامتثال للشرعية الإسلامية، في حين يتبع المصرف الإسلامي بنغلاديش المحدود (IBBL) عملية "التدقيق الشرعي الداخلي" في معاملاته، غير أنه لا يوفر تدقيقًا شاملاً للحسابات وفحص المعاملات بعد تنفيذ العقود. لذا كان من المهم إجراء دراسة مقارنة تحليلية لإطار موحد للتدقيق الشرعي في المصرفين المذكورين، ويتمثل الهدف الرئيس من هذا البحث في مناقشة المسائل ذات الصلة بمراجعة الامتثال للشرعية الإسلامية وتقييم النطاق من خلال دراسة الممارسات الحالية للتدقيق الشرعي في المصرفين، ويسلك الباحث نهجًا نوعيًا، فيستخدم المنهج التحليلي الوصفي لمناقشة القضايا النظرية للتدقيق الشرعي، والطريقة التجريبية بمقابلات شبه هيكلية مع أعضاء اللجان الشرعية للمصرفين. ومن أهم النتائج التي توصل إليها الباحث أن ممارسة التدقيق الشرعي تعزز النزاهة والتطوير الفوري للمصرفين محل الدراسة. وأن المصرفين استخدمتا مصطلح "الامتثال للشرعية"؛ للدلالة على الفهم العام والمسؤولية والمساءلة من خلال التحقق من كل نشاط من نشاطاتهما وضمائهما، في حين استخدمتا مصطلح "الرقابة الشرعية" للإشارة إلى التقييم الدوري. كما ظهر أن مفهوم التدقيق الشرعي أوسع بكثير من المجالات الأخرى للممارسات المصرفية الإسلامية التي تغطي عمليات التدقيق الشرعي، وأنه يجري تطوير التدقيق الشرعي في المصرفين على أساس قدراتهما، مع التنبيه إلى أن الإطار القانوني وإطار الحوكمة الشرعية في المصرف الماليزي أكثر شمولاً منه في المصرفي البنغالي. وعليه يرى الباحث أن هذا البحث نجح في تحليل الممارسات الحالية للتدقيق الشرعي في المصرفين. وقد قدّم عددًا من التوصيات إلى إدارة المصرفين الماليزي والبنغالي، واللجان الشرعية وممارسي التدقيق الشرعي في ماليزيا وبنغلاديش.

APPROVAL PAGE

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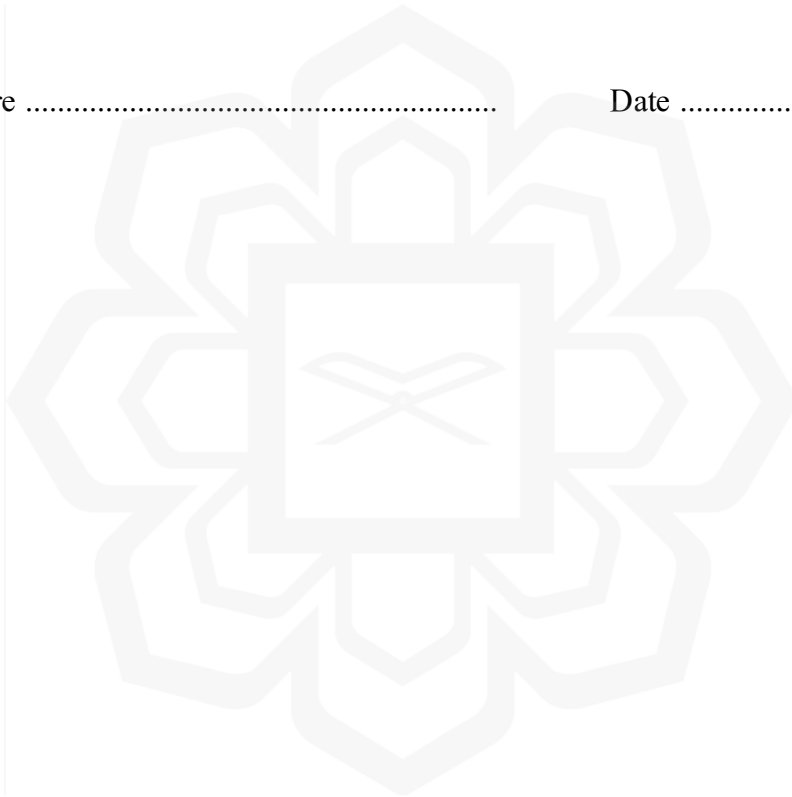
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DECLARATION

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*To my beloved parents who have not just brought me up but included
the inspiration and love of knowledge into my mind and soul;
And
To my beloved wife and two daughters for their support and
encouragement. I do pray for all of them to Almighty for blessed lives
and good health.*

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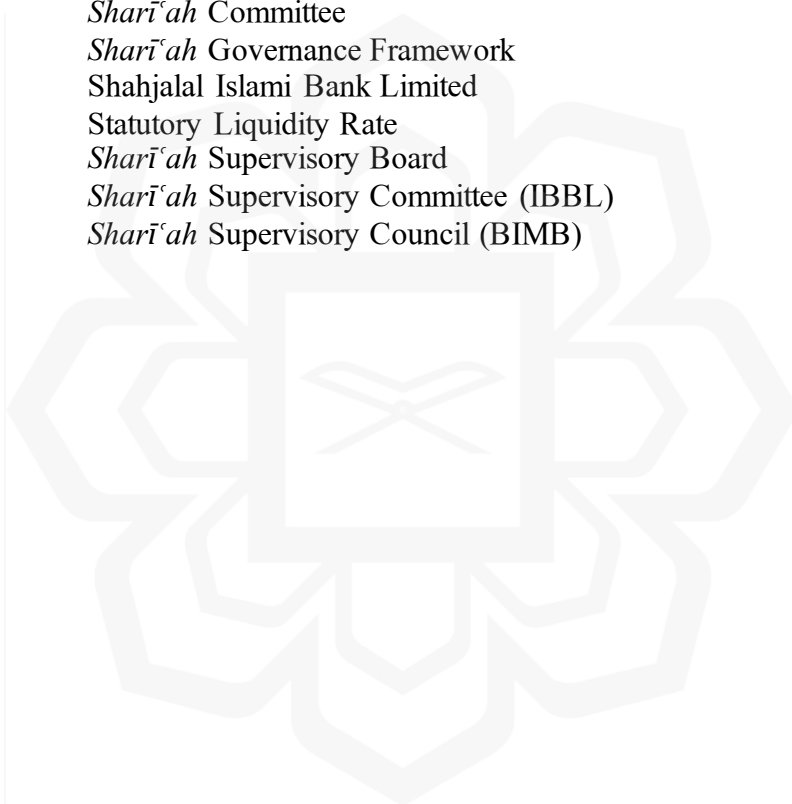
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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial
Institutions	
AC	Audit Committee
AGC	Audit and Governance Committee
BAFIA	Banking and Financial Institutions Act
BB	Bangladesh Bank
BCA	Banking Companies Act
BIBA	Bangladesh Islamic Bankers Association
BIBM	Bangladesh Institute of Bank Management
BIMB	Bank Islam Malaysia Berhad
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia
BMS	Business Management Systems
BoDs	Board of Directors
BRPD	Banking Regulation & Policy Department
CBMA	Central Bank of Malaysia Act
CRR	Cash Reserve Ratio
CSBIB	Central <i>Sharī'ah</i> Board for Islamic Banks of Bangladesh
CSSC	Central <i>Sharī'ah</i> Supervisory Committee
DBI	Department of Banking Inspection
DIB	Diploma in Islamic Banking
DMI	Dar-al-mal-al-Islami
DSE	Dhaka Stock Exchange
EXIM	Import Bank of Bangladesh Limited
FSR	Financial Stability Report
GSC	Governance of the <i>Sharī'ah</i> Council
IAIB	International Association of Islamic Banks
IBA	Islamic Banking Act
IBBL	Islami Bank Bangladesh Limited
IBF	Islamic Banking and Finance
IBCF	Islamic Banks Consultative Forum
IBTRA	Islami Bank Training and Research Academy
IDB	Islamic Development Bank
IERB	Islamic Economics Research Bureau
IFI	Islamic Financial Institution
IFIs	Islamic Financial Institutions
IFSA	Islamic Financial Services Act
IFSB	Islamic Financial Services Board
IiBF	IIUM Institute of Islamic Banking and Finance
IIFI	International Islamic Finance Industry
IIFM	Islamic interbank Fund Market
INCEIF	International Centre for Education in Islamic Finance
ISA	International Standards on Auditing
ISAS	Internal <i>Sharī'ah</i> Audit Section

ISRA	International <i>Shari'ah</i> Research Academy for Islamic Finance
IT	Information Technology
KSA	Kingdom of Saudi Arabia
LCs	Letters of Credits
MIFC	International Islamic Financial Centre
NSAC	National <i>Shari'ah</i> Advisory Council
OIC	Organization of Islamic Cooperation
PBL	Prime Bank Limited
RDID	Research Development & Innovation Department
RMC	Risk Management Committee
RMF	Risk Management Framework
RMU	Risk Management Unit
RMW	Risk Management Wing
SAC	<i>Shari'ah</i> Advisory Council
SC	<i>Shari'ah</i> Committee
SGF	<i>Shari'ah</i> Governance Framework
SIBL	Shahjalal Islami Bank Limited
SLR	Statutory Liquidity Rate
SSB	<i>Shari'ah</i> Supervisory Board
SSC	<i>Shari'ah</i> Supervisory Committee (IBBL)
SSC	<i>Shari'ah</i> Supervisory Council (BIMB)



TRANSLITERATION TABLE

A. Consonant

b = ب	z = ز	f = ف
t = ت	s = س	q = ق
th = ث	sh = ش	k = ك
j = ج	ṣ = ص	l = ل
ḥ = ح	ḍ = ض	m = م
kh = خ	t = ط	n = ن
d = د	ẓ = ظ	h = ه
dh = ذ	‘ = ع	w = و
r = ر	gh = غ	y = ي

B. Vowel

Short vowel	Transliteration	Long vowel	Transliteration
َ	A	ا، آ	ā
ِ	I	ي	ī
ُ	U	و	ū

C. Diphthong

Diphthong	Transliteration
َ و	Aw
ِ ي	Ay
ُ و	Uww
ِ ي	Iy,ī

CHAPTER ONE

INTRODUCTION

In the Name of Allah, the Most Gracious and the Most Merciful.

All praises be to Allah (s.w.t), peace be upon His Messenger Muhammad and his family and Companions. Allah (s.w.t) says: “*And whatsoever the Messenger gives you, take it, and whatsoever he forbids, abstains from it and fear Allah (s.w.t). Verily, Allah (s.w.t) is severe in punishment*”. (Sūrat al-Ḥashr, 59: 7). In another verse, Allah (s.w.t) mentions “[t]hen, as for him who is given his record in his right hand, He will be judged with an easy account, and return to his people in happiness.” (Sūrat al-Inshiqāq, 84: 9).

1.1 BACKGROUND OF THE STUDY

Islam encourages Muslims to follow the religion comprehensively and to act out all operations according to *Sharī‘ah* values.¹ Practicing *Sharī‘ah* entails not only obeying Allah (s.w.t) by worshiping Him, but it is also inclusive of other righteous deeds in all aspects of life. Over the last four decades, the Islamic financial industry has experienced rapid growth throughout the world. According to Yaacob and Donglah, more than one trillion U.S. dollars of assets are managed by global Islamic Financial

¹ The word ‘*Sharī‘ah*’ is an Arabic word derived from the letters (Shīn, Rā’, ‘Ayn). Literally, the meaning of *Sharī‘ah* is “path” or “way”. The term ‘*Sharī‘ah*’ is defined by the Arabic Dictionary ‘Lisān al-‘Arab’ as watering place from which people can drink or draw water. According to the World Encyclopedia (2005), *Sharī‘ah* is defined as the “traditional law of Islam”. The Oxford Dictionary of English (2005) mentions that *Sharī‘ah* is merely a collection of laws and regulations. *Sharī‘ah* has been defined also by many scholars, among them Mohammad Akram (2006) who states that it is an Islamic teaching and guidance to regulate all human actions in *‘ibādāt* and *mu‘āmalāt*. According to Haron Din, et al. (2003) it is not a term created by people but revealed by Allah (s.w.t). Another definition by Hisham (2006) that states that the *Sharī‘ah* is a path towards the religion. While the word ‘compliant’ defines as “made or done according to particular rules and standard”. So the phrase “*Sharī‘ah* compliant” refers to the activities which are made or done according to the rules and standard of *Sharī‘ah*.

Institutions (IFIs). More than 600 monetary companies work with Islamic economic products in over 75 nations.² Thus, *Shari'ah* compliant banking and finance have presently become an important legal and commercial issue in the global economy. In addition, Islamic banks express their suitability based on *Shari'ah* compliance and *Shari'ah* audit³ and review process of *Shari'ah* legal contracts. For this reason, Shahul and Yaya argue that *Shari'ah* audit plays a key role in growing awareness among the IFIs to achieve the *maqāṣīd al- Shari'ah* (objectives of *Shari'ah*).⁴ Syed Alwi Mohamed Sultan suggests that *Shari'ah* audit must be practiced in all activities relating to the system, including financial products, environment, employees, and society.⁵ Therefore, it is necessary to develop IFI's with a *Shari'ah* audit framework to determine the level of *Shari'ah* compliance. Without the *Shari'ah* audit process, there would be a practical gap in *Shari'ah* compliance procedures in Islamic financial operations. This gap in the Islamic financial scheme is regarded to be a significant loophole. Therefore, *Shari'ah* auditors must ensure that *Shari'ah* ethics, and guidelines and values are followed by IFIs. As a result, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain helps in

² Hisham Yaacob and Nor Khadijah Donglah, "*Shari'ah* Audit in Islamic Financial Institutions: The Postgraduate's Perspective", *International Journal of Economics and Finance*, (vol.4, no.12, 2012), 224-239.

³ *Shari'ah* audit programs are a manual-based document that clearly explains out step-by-step *Shari'ah* audit procedures, policies, and processes when offering Islamic financial services. See: Abdul Rahim Abdul Rahman, *Shari'ah* Audit for Islamic Financial Services: The Needs and Challenges (ISRA Islamic Financial Seminar, 11 November 2008). Moreover, the AAOIFI's Auditing Standards (2010) mention that the objective of *Shari'ah* audit is:

The auditors express an opinion through their depth observations in all material aspects of financial issues in accordance with the fatwas, ruling, guidelines issued by the *Shari'ah* Supervisory Board of the Islamic financial institutions, the accounting standards of AAOIFI, international and national accounting standards and practices, and relevant legislation and regulations applied in the country where the Islamic financial institution operates.

⁴ Shahul Hameed Mohd. Ibrahim and Rizal Yaya, "The Emerging Issues on the Objectives and Characteristics of Islamic Accounting for Islamic Business Organization", *The Journal of Malaysian Accounting Review*, (vol. 4 no. 1, July 2005), 75-92.

⁵ Syed Alwi Mohamed Sultan, *A Mini Guide to Shari'ah Audit for Islamic Financial Institutions: A Primer*, (Kuala Lumpur: CERT Publication, 2007), 23.

regulating *Shari'ah* auditing issues and provides the canons of auditing, governance and *Shari'ah* compliant for IFIs. In the Malaysian context, the Central Bank of Malaysia (BNM) issued guidelines under the *Shari'ah* Governance Framework (SGF) since 2010 and the Islamic Financial Services Act 2013 (IFSA) which specified that the *Shari'ah* audit must be conducted in IFIs following the BNM guidelines. SGF 2010 states about *Shari'ah* audit as follows:

Shari'ah auditing should be conducted by the internal auditors of the Internal Audit Department and they should be competent in terms of *Shari'ah* knowledge and understanding the *Shari'ah* issues related to Islamic banking products and operations. All the financial Institutions in Malaysia should comply with this new guideline by January 2011.⁶

Since the inception of Islamic banking in Malaysia, sixteen commercial Islamic banks operate in Malaysia and Bank Islam Malaysia Berhad (BIMB) has become one of the symbols of the *Shari'ah* compliant banks. The practices of *Shari'ah* audit in BIMB mostly adhere to BNM's guidelines since the beginning of its operation despite having its own *Shari'ah* audit manual. However, the guidelines for *Shari'ah* auditing are viewed as insufficient taking into consideration that the *Shari'ah* audit is the backbone of IFIs' operations.⁷ On the other hand, in Bangladesh, eight full-fledged Islamic banks and seventeen commercial banks operate a *Shari'ah* banking system following Islamic principles. Islami Bank Bangladesh Limited (IBBL) currently uses a *Shari'ah* review process by a *Shari'ah* Supervisory Committee (SSC) to examine banking transactions, products and contracts after execution. Nevertheless, there is still a functional gap between *Shari'ah* audit and *Shari'ah* review process.

⁶ Bank Negara Malaysia, *Shari'ah Governance Framework for Islamic Financial Institutions*, (Kuala Lumpur: 2010).

⁷ Abdul Ghafar b. Ismail & Achmad Tohirin, "Islamic Law and Finance", *The Journal of Humanomics*, (vol. 26, no. 3, August 2010), 178-199.

This research attempts to identify the scope of the *Shari'ah* audit to implement *Shari'ah* compliance in the IFIs. In this regard, the researcher thinks that much research is still needed in BIMB and IBBL towards developing a structural framework of Islamic banking and finance, particularly in the area of *Shari'ah* audit. This is a comparative study focusing on *Shari'ah* audit issues between BIMB in Malaysia and IBBL in Bangladesh. Although many studies have been conducted on the issues of *Shari'ah* audit, there is no comparative study between two banks in Malaysia and Bangladesh that focuses on the aforesaid subject matter.

1.2 STATEMENT OF THE PROBLEM

The dynamism of the Islamic banking and finance industry has increased the demands for *Shari'ah* audit to be more effective and integrated to provide better services for stakeholders. *Shari'ah* audit is viewed as a comprehensive process for all activities and products. In addition, the scope of *Shari'ah* audit is much wider and covers other relevant issues along with normal economic activities. However, most of the *Shari'ah* scholars have opined that the *Shari'ah* auditors need to address issues of *Shari'ah* audit with integrity, independence, professional competence, confidentiality, professional behavior, and technical standards succeeding Islamic directions, principles, ideologies, and jurists' *fatāwā* (opinions) appropriately.

In implementing the *Shari'ah* audit, the majority of the financial institutions in the Islamic banking and finance sector follow the AAOIFI guidelines issued in 1992. Since then, there are 18 required issues and five standards of the *Shari'ah* governance system to comply with the IFIs. The Bank Negara Malaysia (BNM) issued guidelines on the *Shari'ah* Governance Framework (SGF) on May 2010. Following this, the Malaysian Government introduced a new policy and guidelines in January 2013 which

must be complied by all IFIs in Malaysia. To understand the research contention of this study, it is essential to realise that there are two types of *Sharī'ah* compliance i.e. (i) ex-ante *Sharī'ah* compliance ⁸ (ii) ex-post *Sharī'ah* compliance.⁹

Presently, BIMB follows the “*Sharī'ah* Governance Framework” which is mostly monitored and scrutinized by the *Sharī'ah* committee as ex-ante *Sharī'ah* compliance. Therefore, it is observed that the “*Sharī'ah* Compliance Audit Framework” may be adopted as rules in executing ex-post *Sharī'ah* compliance or external *Sharī'ah* compliance. As a result, scholars argue whether current practices of *Sharī'ah* audit are considered insufficient or gaps remain between the standards and actual practices. To some extent, a limited number of financial institutions take on ex-post *Sharī'ah* compliance with restricted scope.

The ex-ante *Sharī'ah* compliance in IBBL is also supervised, monitored and controlled by a SSC known as “Internal *Sharī'ah* Review” process in transactions and businesses of banks. It does not include, however, an extensive audit mechanism for reviewing transactions following execution of contracts. In contrast, the ex-post *Sharī'ah* compliance audit system is rare in IBBL. Therefore, a comparative study for a standard framework of *Sharī'ah* audit is essential for the current *Sharī'ah* audit practices. This study is, therefore, an effort to discuss the different aspects of *Sharī'ah* audit comprehensively.

⁸ The ex-ante *Sharī'ah* compliance is the supervision, monitoring and control the tasks that take place upon and during the implementation of bank dealings by the *Sharī'ah* Supervisory Committee (SSC). It includes all activities of the banks and financial institutions that comply with *Sharī'ah* guidelines during the designing of contracts, process of transactions and execution of the contacts.

⁹ The ex-post *Sharī'ah* compliance is considered an in-depth audit process to recheck and scrutinize the transactions after the contract is executed by the authority. It performs the random samples of completed transactions to ensure that all transactions are in accordance with *Sharī'ah* rules.