

A Review of *Shariah* Auditing Practices in Ensuring Governance in Islamic Financial Institution (IFIs) – A Preliminary Study

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ABSTRACT

The main objective of *shariah* auditing¹ is to embrace the *Maqasid As - Shariah* (Objective of Islamic Principles) as well as to uphold the *shariah* principles in all business processes. *Shariah* auditing goes beyond the usual attestation and assurance for the financial statement, internal control and governance of firms and specified by the Central Bank of Malaysia (BNM) in *Shariah* Governance Framework (SGF, 2010), to be conducted by internal auditors. This paper discusses current practices of *shariah* auditing among Islamic Financial Institutions (IFIs) in Malaysia. Data reported in this paper is obtained through 15 semi-structured interviews conducted with chief internal audit, managers of internal audit department, *shariah* committee, external auditor and academicians. Findings indicated that the practices are still evolving where further developments and improvements are required focusing particularly on standardization of *shariah* audit framework and guidelines to design audit program for *shariah* auditing. In addition a proper design of competency framework for auditors performing *shariah* audit is highly recommended

Keywords : Auditing, Internal auditing, Islamic auditing, Islamic banking and finance, Internal control and Governance.

INTRODUCTION

The emergence of Islamic financial institutions (IFIs) has created a new phenomenon within the global finance arena and particularly in the development of Islamic economics and finance. Considerable attention has been given in the area of Islamic economics and Islamic finance, though much work is still necessary in supporting sustainable practices in Islamic finance, particularly in the areas of accounting and auditing. This needs arise as both of these areas provides underlying support to the development of Islamic financial institutions. Recent studies have shown an emerging concern with the interaction of business activity and Islam

¹ According to *Shariah* Governance Framework for Islamic Financial Institutions” (SGF, 2010) issued by the Central Bank of Malaysia (BNM), defined *shariah* audit as “the 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* (Islamic) compliance”.

(Abdel Karim, 2001; Alam, 1991; Gambling & Karim, 1986; Hamid et al., 1993; Mirza & Baydoun, 1999). Islam recognized business activities as act of worship and obedience to Allah (*ibadah*) if they are performed in accordance with the commands of Allah and the Islamic code of conduct Ahmad (1988). This can be interpreted from several Quranic verses, in example verses 2:30; 14:32-33 and 31:20.

Recognizing the importance of business in daily human lives, and the needs for compliance with Islamic principles, Islamic banks have been established to assist Muslims and Islamic societies particularly in avoiding the interest which is prohibited in Islam as well as controlling their financial affairs to only covered halal areas. Thus, IFIs attracted their customers by complying with all *shariah* principles in their dealing and business activities. Such confidence however cannot be developed without several important measures which are the, i), disclosures to users (customers) about bank's compliance with *shariah* principles, and ii) independent attestation and assurance that their business complied with all *shariah* principles (Ahmad, 1988). Occurrences of *shariah* non-compliance activities also can tarnish IFIs' reputation and deteriorate reliance of depositors, investors, customers and other stakeholders (Dusuki, Ali, and Hussain, 2012) and Shafii, Supiah, and Syahidawati, 2010). Therefore, having a sound *shariah* auditing processes help IFIs in maintaining their credibility and reputation while reducing the risk of *shariah* non-compliance issues, which can cause great damage and losses if IFIs is subject to legal actions when they fail to address *shariah* non-compliance issues properly.

As such, recent development in the Malaysian context pertaining to *shariah* auditing and *shariah* review have been outlined in the guidelines "Shariah Governance Framework for Islamic Financial Institutions" (SGF) issued by the Central Bank of Malaysia (BNM) on 20 May 2010. The guidelines emphasized that *shariah* auditing be conducted by the Internal auditors from the internal audit department of IFIs and the internal auditor should be competent in terms of *shariah* knowledge and understanding on the *shariah* issues related to Islamic banking products and operations.

RESEARCH OBJECTIVE

There is no doubt that Islamic finance industry will continue to be an important component of the global financial industry. The continuous progress of the industry will ultimately depend on the ability to successfully promote the concept of Islamic finance and the ability to offer the true benefits and assurance of Islamic finance practices to the market. Having an overview on what constitute the best practice in accordance to *shariah* principle would help IFIs to improve their practices and enhance their stakeholders' confidence. External auditing has a long history in finance, serving as one of the effective mechanisms to provide assurance concerning the reliability of financial transactions and statements. As expected, there is an extensive literature regarding external auditing for public and private sectors. However, in the *shariah* auditing literature, discussion on external auditing mainly takes the perspective of external auditors and *shariah* committee. Being a relatively new financial construct, several criticisms and controversies are inevitable due to the lack of empirical evidence that deals with the real practices of *shariah* auditing among internal auditors in IFIs. Thus, this study fulfills the gaps in *shariah* audit literatures. This study explores existing issues and challenges to gain an in-depth knowledge regarding current *shariah* auditing practices, especially those experienced by the internal auditors themselves.

Thus, the issue of *shariah* compliance is clearly a major challenge to IFIs and the regulators. Abdallah (1994), Alwi (2007) and Abdul Rahman (2008b) , listed two types of *shariah* compliance which are (i) ex-ante compliance and (ii) ex-post compliance. The ex-ante *shariah*

compliance normally has been practiced by IFIs as they have *Shariah* Supervisory Board (SSB) to supervise, monitor and control the task that takes place upon and during implementation of the bank's dealing. The SSB is responsible to ensure that the IFIs comply with the *shariah* rules and guidelines during the designing of the contracts and agreements, during the process of transactions, conclusion and execution of the contract. However, Abdul Rahman (2008b) stated that very few institutions undertake ex-post *shariah* compliance process because it requires thorough and comprehensive *shariah* audit to review and check the transactions that happens after the contracts' execution. Hence, this study is to discuss and identify current practices of internal auditor regarding *shariah* auditing issues especially after the issuance of *Shariah* Governance Framework for IFIs by BNM in terms of scope, objectives, framework, current practices and required knowledge among internal auditors in IFIs in Malaysia.

The study aims to provide descriptive information for standards' setters and regulatory bodies in coming up with relevant standards and *shariah* audit programs. This can only be done after having clear understanding on the concept, principles, objectives and approaches of *shariah* audit. This study also aims to recommends appropriate skills required of the internal auditors before they can conduct *shariah* audit. The basic knowledge for internal auditors of IFIs are ability to apply current auditing standards and procedures, strong knowledge of Islamic Legal Maxims relating to Islamic banking products and operations.

LITERATURE REVIEW ON SHARIAH AUDITING ISSUES

Funkhouser & Greeno (1984) defined auditing as a methodical examination involving analysis, tests and confirmations of local procedures and practices leading to a verification of their compliance with legal requirements, corporate policies and accepted policies. Another similar definition is from Arens & Loebbecke, (1998) which defined auditing as the process by which a competent, independent person accumulates and evaluates evidence about quantifiable information related to a specific economic entity for the purpose of determining and reporting on the degree of the correspondence between the quantifiable information and established criteria. In terms of accounting literature, there were extensive researches that highlight the difference between Western and Muslims business environments where most of the researchers concluded that there must be a system of accounting and reporting because of different objectives and concept in Islamic business practices compared to western practices. Abdul Rahman (2007), (2008a); Gambling and Karim (1986); Hameed (2000); Karim (1995); Mirza and Baydoun (1999); Tag El-Din (2004) and many also viewed that current or conventional accounting cannot be used by the Islamic banks and financial institutions (Adnan & Gaffikin, 1997; Adnan, 1996; Alam, 1991).

However, very limited studies have been devoted to the subject of *shariah* auditing compared to the study done in the area of Islamic accounting and conventional auditing. Most of studies in auditing concentrate on conventional audit which emphasize more on the accuracy and relevancy of financial audit (Khan, 1985).

What actually makes *shariah* audit become crucial in the Islamic banking practices? The answer is because of the result of the phenomenal growth of Islamic banking and finance which the main responsibility of the IFIs is to adhere to *shariah* principles and rules in all its activities. Normally, mind setting of customers and depositors towards IFI has always been proclaimed as an institution that different from conventional banking in many aspects. The first and most significant difference is the abolition of *riba* in all its financial transactions (Dusuki et al., 2012) and *shariah* compliance in all activities. Therefore, the public's confidence towards the industry of Islamic banking is believed to be vital. To build the public's confidence, there are so many approaches which can be done by IFIs. One of the approaches is through

giving assurance and attestation that their operations and their financial products is accordance to the *shariah*. This can only be done through conducting audit on their operations based on the *shariah*, instead of conventional audit (Besar *et al.*, 2009). A particular confidence feature in respect of Islamic financial services is the requirement of conveying to stakeholders that their financial business is conducted in conformity with their religious beliefs Grais and Pellegrini (2006). Abdul Rahman (2008b) agreed that the *shariah* compliance is the cornerstone of Islamic financial products and services, if the customers find that the products that they have in their portfolio are not *shariah* compliant, this would seriously undermine the confidence in the Islamic Financial services industry as a whole. Therefore, according to Abdul Rahman (2008b), the role of regulator in promoting *shariah* audit is important.

In the Malaysian context, the Islamic Banking Act (IBA) 1983 had provided the provision for the establishment of *Shariah* Advisory Board as a requirement of granting license to an IFI. In addition to the IBA (1983), the Malaysian Accounting Standards Board has issued the "Financial Reporting Standards - *i* (FRS - *i*). The purpose of the standard is to provide a guideline which is *shariah* compliant as well as applicable in the Malaysian context in order to address accounting issues and practices in Malaysia (MASB, 2004). Recent development pertaining *shariah* auditing and *shariah* review has been discussed in the guidelines "*Shariah* Governance Framework for Islamic Financial Institutions" (SGF) by the BNM on 20 May 2010 which has superseded the *Shariah* Governance Framework for Islamic Financial Institutions (2005). All the IFI in Malaysia should comply with this new guideline by January 2011. This guideline consists of three main organs i.e. the board, the management and the *shariah* committee. Each of these organs is interdependent in ensuring that the IFI is *Shariah* compliant at all time. These organs are supported by 3 functions namely; (1) a *shariah* risk management control function that is able to identify all possible risk of *shariah* non-compliance and, where appropriate, remedial measures to manage this risk; (2) a *shariah* review function that continuously assesses and monitoring *shariah* compliance of all activities and operations; and (3) a *shariah* audit function that performs annual audits to provide an independent assessment of the adequacy and compliance of the Islamic financial institution with established policies and procedures, this is to ensure that the adequacy of internal control is designed by IFIs and to undergo the access of the adequacy of the *shariah* governance process.

Study done by Kasim *et al.* (2009) indicated that the practice of *shariah* auditing has not seriously given impact to IFIs in Malaysia due to the lack its own *shariah* auditing framework because the practice of *shariah* auditing is still a highly unstructured task. Abdallah (1994) highlighted that, none of the bank and financial institutions perform the ex-post *shariah* audit. According to him, the ex-post *shariah* audit is basically to perform the random samples of completed transaction to ensure that these transactions conform to *shariah* rules and regulation. In fact, Besar *et al.* (2009) also highlighted the same issue as they noted from the *shariah* committee report currently provided by the respective banks *shariah* committee, it lacks the depth of providing such assurance. It is merely an endorsement of the bank's *shariah* compliance in general without any emphasize on the actual operational or conduct of the respective banks.

The role of conventional auditor in the Islamic practices has been widely criticized by many *muslims* scholars. As Khan (1985) argued that the role of conventional auditor in the capitalist framework is solely answerable and provide assurance and attestation to the management and shareholders of the company on particularly on the financial matters while the role of auditor in Islamic economy are totally different as they are responsible to the society at large and to uphold the Islamic principles. Khan (1985) argues that: "*The scope of auditing in Islamic framework is much larger as compared to the scope of traditional auditing. From the traditional*

concept of attest and authority it would expand to report on various social and economic aspects of business organization. This is due to the reason that auditing in Islam has been derived from the basic values of Islamic societies and shariah principles". Therefore, due to the establishment of Islamic economics system and Islamic financial system, the function of auditors and shariah experts need to be revised to suit the requirements of the system (Ahmed and Karim, 2001; Al-Abiji, 1998; Khan, 1985). Al-Abiji (1989) stated that the roles of auditor changes in all its dimensions in accordance with the economic, political and social changes that take place.

Hood & Bucheery (1999) opined that religious auditor is guided by religious beliefs prescribed in *Quran, Sunnah* and *Ijma'* which would be more highly regarded compared to the legal rules and professional code of ethics. While Abdel Karim, (1990) differentiate the roles of shariah auditor and external auditor as he stated that the role of external auditor is focus on the compliance of accounting regulations to ensure that financial reports present fairly the economic situation of the company. While the role of shariah auditor is to focus on an adherence to Islamic precepts to assure its Islamic constituents that the reports reflect a genuine commitment to Islamic business principles. Abdel Karim (1990) further argued that shariah auditor is very much influenced by moral values while the external auditor is largely affected by economic factors. As a conclusion for literature review, by analyzing the existing literature and the current state of auditing for Islamic Banks, it can be concluded that shariah auditing still face many unresolved issues such as establishment of shariah auditing framework and unclear understanding on the auditor's roles while they conducting auditing procedures in Islamic banks.

RESEARCH METHODOLOGY

This study employs a series of interviews conducted between 2014-2015 with individuals involved in shariah audit from several backgrounds. The overall aim of the interviews is to discover the current practices of shariah auditing and to elicit the level of understanding and knowledge of those who are involved in shariah auditing. Specifically, the interviews focused on two main themes. First, the interviews focused on the definition of shariah auditing from the individuals perspectives and second theme is focused on investigating current practices of shariah auditing which then divided into seven sub sections namely:

1. Scope and extent of shariah auditing
2. The current framework adopted by the IFIs
3. Relationship with shariah review and shariah committee
4. Governance and reporting line of internal auditor
5. Competency requirement
6. Challenges and limitation

Fifteen (15) in-depth interviews were conducted as follows:

Table 1: List of Respondents' Designation

Respondents	Designation	Respondents	Designation
R 1	Chief internal Auditor	R 9	Manager of internal audit department
R 2	Chief internal Auditor	R 10	Shariah Committee
R 3	Chief internal Auditor	R 11	Shariah Committee
R 4	Head of Shariah audit	R 12	Shariah Committee
R 5	Senior Manager	R 13	Shariah Committee
R 6	Senior Manager	R 14	Shariah Advisor BNM
R 7	Senior Manager	R 15	Executive Director of External Audit
R 8	Manager of internal audit Department		

Diverse participant's background is chosen to ensure that the study gauges the overall practices of *shariah* auditing from top to bottom level. All participants reported having at least 2 years' experience in performing *shariah* auditing. The interviews were tape recorded and each interviews lasted approximately 2 hours. Interviews were conducted at the participant's organization and an interview guideline is sent via email prior to the interview session (see appendix 1 for the interview guideline). The purpose of the interview guideline is to elucidate the information required such as themes or issues that will be discussed during the interview sessions. All participants appeared confident and seemed to have a very good understanding of the organizations background, structures and process of *shariah* auditing.

The interviews were then transcribed and coded using the key themes related to the main research objectives and subsequently re-checked for errors in the classification of themes by reviewing them and reaching a consensus before pre-coding. This practice is adopted from Zain (2005) and Patton (2002). The interview responses were then presented in the form of matrix framework. This is important in order to compare the responses across the fifteen (15) interviews that have been conducted. The matrix format highlights the presence or absence of consistency and consensus across different responses which proven to be useful to identify commonalities and differences in the research themes (Miles and Huberman, 1984 and Martin and Meyerson, 1988) – as quoted in Zain (2005).

FINDINGS AND DISCUSSIONS

Definition of *Shariah* Auditing

All fifteen (15) respondents understood the definition of *shariah* auditing as stated in the *Shariah* Governance Framework for Islamic Financial Institutions (SGF) (2010) issued by the BNM which stipulated that *shariah* auditing is the periodical assessment to validate and give assurance that the internal control of the company is effective and efficient to be preserved and complies with *shariah* principles. All the respondents are also in agreement that, *shariah* auditing function is important for banks to reduce *shariah* non-compliance and other *shariah* risks. Besides that, internal audit department is expected to act as consultants to other departments in setting up a sound and effective internal control aligned to *shariah* principles. Among the responses are:

“shariah auditing is important to perform as it will help to reduce shariah risk. Shariah risk is very essential and important. If we not properly manage shariah risk, it will lead to other risks such as credit risk, operational risk, reputation risk and etc.” [Respondent 1].

“...in our internal audit department, we adopt ERM (Enterprise risk management) and COSO framework to identify our shariah audit risk. Bank have their own policies, so we need to know risk for each of policies and then incorporating to audit procedures. We also audit our systems whether it is any risks in the system” [Respondent 2]

However, a respondent who is an external auditor in one of the big four audit firms in Malaysia expressed an interesting point about the current practices of *shariah* auditing in IFIs which he thinks is not sufficient to reduce risks for banks. He said:

“unclear understanding and approach from the internal audit department in terms of (i) lack of systematic approach and methodology, (ii) lack of link into the work have been done and the end results and (iii) lack of definition on what of the objectives that they try to achieve” [Respondent 15].

When asked about the definition of *shariah* auditing as compared to conventional auditing, majority of the respondents, thirteen (13) of them, suggested that the definition and practices

of *shariah* auditing and conventional auditing is similar except for the main objective of *shariah* auditing is to ensure sound and effective internal control for *shariah* compliance. However, the other two respondents view *shariah* auditing methodology and definitions to be different compared to conventional audits. They said that:

“previously, yes we can say it is similar to conventional or normal audit procedures, but then, at current state, we are moving towards specific shariah auditing objectives, process and approach because we concerns on shariah risk and non-compliance issue” [Respondent 4 and 7].

However, all respondents agreed that the process of *shariah* auditing is more effective and sound if the internal auditor has relevant and adequate knowledge on Fiqh Muamalat and Islamic legal contracts/maxims. The knowledge of these two areas will enhance the process of auditing as the internal auditor will be more appreciative and alert on the issues of *shariah* non-compliance. This knowledge requirement is also a factor which differentiates the *shariah* auditing from conventional. Among the responses are:

“...Most of internal auditors understand their roles and functions, but due to lack of knowledge, some of them still unclear between shariah auditing process and shariah review process. In fact, internal auditors tend to conduct shariah audit only based on audit checklist – which showing that they not really understand the objectives and justifications if shariah non-compliance issues” [Respondent 10]

“... from my observation, many internal audit in IFIs still don't understand shariah auditing functions. Therefore, they still unable to provide an assurance regarding internal control effectiveness and efficiency. This could be due to lack of shariah knowledge and unclear of shariah auditing objective itself” [Respondent 8 and 11].

“...shariah auditing consists of different audit objectives – as it should always target to achieve maqasid of shariah. Therefore, shariah audit should different from normal audit process....internal auditor should have adequate knowledge to contrast the differences” [respondents 4, 10, 12 and 13]

In summary, definition of *shariah* auditing is generally understood by most of the internal auditors. They are also in agreement that, *shariah* auditing's main objective and functions are to reduce *shariah* risk or *shariah* non-compliance risk in IFIs. Nevertheless, all respondents agreed that effectiveness and efficiency of *shariah* audit process and procedure can only be achieved if the internal auditors have good understanding of *shariah* principles and IBF knowledge, which will enable them to comprehend and reasons for any *shariah* non-compliance or issues that arise during *shariah* auditing.

Current Practices of *Shariah* Auditing

This section is a discussion of findings in terms of current practices of *shariah* auditing, and will be divided into six categories of: i- scope and extent; ii- current framework adopted; iii- roles of *shariah* review function and *shariah* committee; iv- governance and reporting line of internal auditors; v-competency and knowledge requirement; vi- challenges and limitations.

Scope and Extent of *Shariah* Auditing

SGF (2010) stipulated that the internal audit department of a bank should play the role of ensuring the compliance with *shariah*. At present, Islamic financial institutions in Malaysia has mushrooming quite significantly including several foreign owned entities and some existing conventional banking institutions, which also established their Islamic banking subsidiaries. Based on the interviews conducted, *shariah* auditing really is performed by the internal audit

department. Only one IFI has a dedicated unit in the internal audit department to specifically perform *shariah* auditing. Majority, fourteen (14), respondents confirmed that all the internal auditors within a department are responsible to perform *shariah* auditing when he or she conducts internal audit on certain Islamic banking operations or products. Majority of the said that even though they do not establish a dedicated unit of *shariah* audit, they have 2-3 internal auditors specialized with *shariah* knowledge relevant to Islamic banking and finance appointed for reference during their *shariah* auditing process. A respondent, which is a regulator said:

"... not many banks have established one dedicated unit of shariah audit. The BNM has also not seen the needs for IFIs industry to establish one specialize unit as it will tighten up the regulatory requirements which at the end will affects the growth of the industry" [Respondent 14].

Respondents also agreed that internal audit department should design their *shariah* auditing program to cover all aspects of IFIs business operation and activities such as the financial statement audit, compliance audit, internal control review, human resources, processes, information technology as well as *shariah* governance review. Respondents' understanding regarding the scope and extent of *shariah* auditing is also in line with SGF (2010). Majority, eight (8), respondents suggested that *shariah* auditing process in their IFIs is either effective or quite effective though their practices are at minimum and have lots of rooms for improvement. However, they agree that *shariah* auditing has only been performed at the surface level. The internal auditors also have difficulties in differentiating the process they need to perform to fulfill conventional versus *shariah* when they perform audit on Islamic products and operations. The internal auditors at times adopts similar processes which is wrong for Islamic banking products and operations which need to be audited in accordance to *shariah* principles. In example, internal auditors has to verify that the *ijarah*² contracts fulfill an *ijarah* contract's conditions according to *shariah* which requires proper evidence of asset's ownership is in place (accounting treatment and claim for capital allowances to local accounting and tax regulations). However, some respondents said that very few internal auditors have good understanding on certain concepts of Islamic banking products and nature of its operation, which caused misinterpretation that lead to *shariah* non-compliance. An external auditor responded:

"... before an internal audit department conduct shariah audit, they should developed a structured methodology in terms of : (i) scoping of shariah audit universe, (ii) shariah risk assessment, shariah audit planning procedures, (iii) audit testing methodology, (iv) reporting and rating methodology, (v) coordination of works performed between shariah review function and lastly, (vi) link between shariah audit opinion and work performed." [Respondent 15]

Three (3), five (5) and three (3) respondents reported that *shariah* auditing practices has been either very effective, effective or quite effective, while only four (4) respondents said that the *shariah* auditing practices at banks is not effective. Generally, the full-fledged Islamic banks have the best practices as evidenced by the respondents which said that *shariah* auditing process is very effective comes from those banks. Majority respondents responded that *shariah* auditing practices have not been implemented effectively because of lack of expertise and short time frame. A respondent said that *shariah* auditing process was not effective due to *"... repetitious of work between shariah audit procedures and shariah review procedures" [respondent 15]*. However, according to one of the respondent which is a regulator from BNM

² *Ijarah* is leasing ; the sale of usufruct of an asset

asserted that the practices of *shariah* auditing process are improving after IFSA 2013 implementation. The response is:

“they are improving...everybody are aware the importance, roles and functions of shariah auditing to reduce shariah non-compliance risks as well as penalty charges for breach of IFSA 2013 , therefore, the practice will improves as new regulatory enforcement – IFSA 2013 was been stipulated to all IFIs.” [Respondent 14].

The Current Framework Adopted by the IFIs

The framework adopted by internal audit department would include standards, audit process, audit program and audit plan. Findings show that internal audit departments generally adopted the International Standards for Professional Practice of Internal Auditing (IPPF) issued by the Institute of Internal Auditors (IIA) and Guidelines on Minimum Audit Standards for Internal Auditor of Financial Institution issued by the BNM. Currently, there are not yet any standards specifically designed for *shariah* auditing. *Shariah* auditing is being performed in all units of business operation, which normally depends on the group internal audit risk assessment and annual internal audit plan conducted by the internal audit department. Eight (8) respondents mentioned that the *shariah* audit uses similar computerized audit program for conventional auditing with only several add on procedures for *shariah* compliance. Only seven (7) respondents stated that their organization has designed a specific *shariah* audit program though improvements are necessary for more systematic procedures and to include standard operating procedures for accounting (MASB, IFSB, etc.), regulatory (BNM) and other requirements.

Meanwhile, in terms of risk assessments, all respondents agreed that their risk assessments are based on group internal audit risk assessment. Given this scenario, an external auditor responded that some issues need to be considered within *shariah* auditing process and risk assessments:

“when internal auditor perform risk assessment in shariah auditing process, the internal auditors need to consider the issues of; compliance checks or risk based audit; how do you define shariah non-compliance risk; who should execute shariah audit? Should IFIs trained Islamic scholar or professional internal auditors trained in Islamic finance?; what is the scope of shariah audit, should encompassing or specifically defined?; should shariah audit be very different that operational audit?; what assurance is shariah audit providing for?; how do you determine the planning and testing methodology, to provide assurance over shariah audit?; and lastly on how do you raise the issues and rate the report?” [Respondent 15]

Respondents were also asked whether it is essential for the IFIs to have its own *shariah* audit framework and program. All respondents noted that the BNM should at least issue a general framework and general list of audit program to be used as a guideline for the IFIs. Having such framework would help IFIs in designing their own *shariah* auditing framework and program specifically catered for their Islamic banking products and operations. However, the SAC BNM's response to this issue is different:

“ I don't think we need to issues a structured shariah audit framework. This is important to ensure the growth and to promote the Islamic banking industry. If regulator is too stringent, the Islamic banking and finance will be too costly and expensive. As such, again it will dampens and condone the Islamic finance industry. For me, continuous education and awareness need to be done aggressively at individual level as well as at management level.” [Respondent 14].

Roles of Shariah Review Function and Shariah Committee in Shariah Auditing

SGF (2010) stipulated that internal auditors may use IFIs *shariah* expertise from *shariah* review department and *shariah* committee for *shariah* audit while not compromising the objectivity and independence. Interviews indicated that the internal auditors have close working relationship with the *shariah* review department especially when confirming *shariah* principles and practices. For instance, when the internal audit department review the *shariah* compliance framework and internal control, they always consulted *shariah* review department. The respondents also clearly understood the needs to assure independence and objectivity as an internal auditor. At present, the *shariah* reviews department usually acts as a referral point for the internal audit department to confirm and clarify *shariah* issues. In addition, all respondents understood the roles of the *shariah* review department which is to ensure *shariah* compliance in all Islamic finance and banking activities. Among the responses received:

"...yes. We do have a close relationship with our shariah review department. They became our referral if we not sure with shariah issue" [respondent 5].

... we work closely with shariah review department. But then we still maintain our independence. They are our auditee"[Respondent 6].

... close relationship with shariah review department and they really clear with their functions. This is important to ensure no repetitious process. Shariah review function is more on monitoring daily function." [Respondent 7].

However, one respondent mentioned that many internal auditors and *shariah* review officers are still unclear about their functions. According to respondent 15;

"...many of them only understand the differences on the conceptual matters, but not clear in terms of operationalized it. I found redundant audit process between shariah audit and shariah review. In practice, they are conducting similar works such as shariah review check legal documents and internal auditor also looking at legal documents. In audit, we more concern on specific matters. Internal auditors conduct shariah audit based on risk based or audit based on checklist?!" [Respondent 15]

Nevertheless, several different practices were found in relating the internal auditor and *shariah* committee. Nine (9) respondents agreed that their internal audit department had a close working relationship with the *shariah* committee, while, two (2) of the respondent stated that they had a quite close working relationship. The other four (4) respondents claimed that the *shariah* committee did not perform an active oversight role on *shariah* audit function. This practice violates the SGF (2010) which stipulates that the *shariah* committee is expected to perform an oversight role on *shariah* matters relating to the institution's business operations and activities which can be done through *shariah* review function and *shariah* audit function. Some of the responses describing this context are:

"...close relationship, but sometimes the SC does not possess sufficient understanding on the whole process of banking activities especially in terms of operational matters. Most of them are only concerns on shariah issues and risk. [Respondent 8]"

"... My observation, shariah committee lacks of understanding on operational matters. They only looks on shariah fatwas on Islamic banking products but at the end of the process, they need to sign shariah audit report which emphasize more on operation of islamic banks whether its comply with shariah or not? I found there is no link and connection between what they have assured in shariah audit report and works that have been performed to ensure their assertion and assurance. [Respondent 9]"

“...they do have close working relationship between internal audit department and shariah committee. But then, I found in some cases, shariah committee itself lack of understanding in terms of banks operational matters” [Respondent 6]

The *shariah* committee's active roles can also be measured through their participation in audit committee meeting. A variance in practices have also been found where two (2) respondents informed that their *shariah* committee is invited to attend the board of directors meeting but not the audit committee meeting. While, another eight (8) respondents stated that their *shariah* committee is invited to attend the audit committee meeting. Two (2) respondents (one of which is from SAC BNM and another is an external auditor) claimed that the *shariah* committee could not play an active role since the management does not understand and refuse to accept the *shariah* committee's roles to assist internal auditors in reviewing the *shariah* auditing process. Therefore, the *shariah* committee was not invited to attend any audit committee meeting or board of directors meeting. One interesting finding from this interview also revealed that in some situations, The *shariah* committee's roles, are denied by the management by limiting and discarding the *shariah* committee active participation in the internal audit department. The following sub - section, reports the the formal reporting channel as practiced by the internal audit department in regard to *shariah* auditing process.

Governance and Reporting Line of Internal Auditor

Interview results show that all IFIs comply with the SGF (2010) guidelines. The internal auditor that audit *shariah* governance and reporting are required to report to their audit committee and *shariah* committee. In addition to that, for *shariah* non - compliance issues, internal audit department would have to also report to the board of directors of the IFIs.

Competency and Knowledge Requirements

All the respondents strongly agreed that Islamic banking and finance (IBF) knowledge, *shariah* knowledge and internal audit knowledge are important to the internal auditors especially when they are to conduct the *shariah* audit. Majority respondents recognized that having the knowledge would help them understand and evaluate the *shariah* issues comprehensively and able to detect and identify violations of *shariah* principles in Islamic banking and finance transactions and operations. Therefore, as postulated in H1 - three(3) most important knowledge required to perform *shariah* audit are Islamic banking and finance knowledge, *shariah* knowledge and internal audit knowledge is supported. SGF (2010) on internal auditor's competency requirement, only outlined general guideline of “the function shall be performed by internal auditors, who have acquired adequate *shariah*-related knowledge and training” (SGF, 2010, Principles 7, Para 7.8). The term “adequate” for knowledge, however, has not been clearly defined by BNM. It is ambiguous as to whether the internal auditors need professional certifications, university qualifications or training hours. Thus, the IFIs industry is still uncertain of their direction on the knowledge requirements for the internal auditors to conduct *shariah* audit. Some responses related to this aspect are captured as follows;

“...Six basics disciplines of knowledge that essential for internal auditors to possess before they can perform shariah auditing effectively are they have to know the Islamic banking operation, shariah muamalat and principles, audit techniques and practices, accounting, commercial law and the whole risk management.[Respondent 14].

“...Exactly! shariah knowledge and Islamic banking and finance knowledge is important to form your justifications and explain for any shariah non-compliance” [Respondent 3].

"...our industry is looking forward or in demand for internal auditors who are expert in IBF and shariah knowledge. However, many of internal auditors are only good in accounting and auditing skills, but lack of IBF knowledge and shariah. Then, if we hire a shariah graduate, we are still need to train and educate them to understand audit and accounting knowledge. Therefore, to get an internal auditor who can understand both disciplines is very challenging. Indeed, they are very demanding!." [Respondent 1].

"..from my observation, many internal auditors still does not understand some of basic shariah principles and IBF knowledge, even though they claimed that their organization have well trained staff. Some of them are still asking me some basic shariah principles, questions. I think, it's good if one research can be conducted to measure competency and knowledge level of internal auditors during shariah auditing process." [Respondent 14].

In addition, an interesting finding from the interviews is that, besides IBF and *shariah* knowledge, spirituality level of internal auditors and IFIs staffs have also been considered as important element for the effectiveness and efficiency of maintaining *shariah* principles in Islamic banking operations. Responses affirming the importance of spirituality in IFIs' operation are:

"...we provide two days of compulsory induction course for our staff. Day one of induction, we teach them about IBF and shariah fundamentals knowledge. Then, on second day of induction course, we emphasize the importance of spirituality. Not so much on muamalat. In fact, sometimes, we as a shariah committee, visited our branch, we called it "usrah" and teach them about spirituality and accountability. As a full fledge of Islamic banks, we should always portray and practice that we preserve our shariah principles." [Respondent 12].

"...For me, shariah knowledge and some other knowledge related to this area such as auditing, accounting, finance and banking are important. However, the principles of the practices still lies within the approach of the individual to understand as their main roles actually is towards God (Allah), accountability to god and their spirituality towards what they believes." [Respondents 13].

On a different note, results from the interviews indicated that the IFIs did not perceive *shariah* knowledge to be important for their staffs. Only three (3) respondents stated that it is compulsory for staffs to attend and participate in Islamic *Fiqh Muamalat*, Islamic Legal Maxims, Islamic accounting and auditing training or workshop. The internal auditors' participation will be evaluated in their key performance indicators (KPI). Meanwhile, another ten (10) respondents stated that their organizations only strongly encourage the staff to attend and enroll in any Islamic banking and finance courses but did not mandate it as a compulsory action that needs to be fulfilled.

Challenges and Limitations

All respondents clearly indicated that their biggest challenge in implementing effective *shariah* auditing is lack of expertise and resources. This would means that many internal auditors have not had adequate *shariah* knowledge and understanding of the Islamic financial system. At the same time, not many *shariah* officers understand the conventional financial system. This makes them more critical when they compared the two streams. The most plausible explanation of this problem is lack of training provided during tertiary education. This also proves the importance of incorporating *shariah* principles in the accounting and finance degree at

universities. Support from management has also found to be a challenge. Majority, eight (8), respondents agreed the vital management need to play in implementing *shariah* auditing practices. While, seven (7) respondents said that management do not perceive *shariah* auditing to be important due to the sentiment that *shariah* auditing is similar to conventional auditing. Among the responses are:

"... Management tends to see shariah audit as a part of conventional, normal audit procedures. They not really appreciate the importance of shariah audit towards shariah compliance process" [Respondent 8].

"... Management still unclear on the roles and functions of shariah review and shariah audit" [Respondent 7].

"I agreed, Management, Shariah Committee and shariah audit department have their own importance role in promoting shariah audit." [Respondent 5].

"... I found a problem of information gap between shariah committee and management. A cooperative management needs to give support. Shariah committee has different objectives and concern. Then, as management's objective is profit maximization. In certain cases, they found shariah committee has limited knowledge on the real operation of the banks. Then, in some cases, shariah auditing findings or shariah reviews findings viewed as not significant issues. Management need to be more transparent. Therefore, internal auditors should play their role in explaining and reporting real situation of the IFIs to both parties especially in terms of lack of internal control and related risk" [Respondent 15].

CONCLUSION

This study provides a descriptive analysis on the actual views of practitioners of the Islamic finance ecosystems with regards to *shariah* auditing. Findings show that IFIs in Malaysia is still working towards establishing an effective *shariah* auditing framework and programs. A study by Kasim et al. (2009) also highlighted that IFIs have to depend on the conventional auditing framework for audit purposes, which is limited in scope, despite the obligation to meet the *shariah* rules. This study also found that *shariah* auditing practices have lots of rooms for improvements in various aspects like (i) improving understanding among the internal auditor, (ii) implementation of *shariah* auditing process and manuals, (iii) fulfilling resources, (iv) *shariah* committee's role, (v) expertise requirement, and (vi) support from management. Then, issues of lack of resource i.e. knowledge, skills are also interesting to ponder. It is also found that generally internal auditors in IFIs are experts for conventional accounting and auditing skills, but lacking in *shariah* and Islamic Banking and Finance knowledge although those knowledge have been recognized as very important by the respondents in performing *shariah* audit. In addition, the present study also found the IFIs should consider to strengthen the intrinsic value among their staffs such as spirituality to be part of their enhancement program which has been found in this study to be an importance factor to improve *shariah* audit process. Such attainment of this intrinsic attribute will be able to guide internal auditors to perform *shariah* audit with deep conviction and zeal, thus improving their *shariah* auditing process. Overall, the empirical findings of this study further enrich the relevant body of knowledge in internal auditing and Islamic banking and finance research. In the present study, only 15 interviews were conducted on a group of internal auditors to provide the qualitative data, which were later analyzed to test one of the research hypotheses. Though the amount of such data may be sufficient for the qualitative analyses used, having additional data may add more credibility to the discussion of the effects of moderating variables. Future research may involve interviews with other groups of IFIs' workforce, such as external auditors and *shariah*

review officers, together with internal auditors, to establish more solid samples. Such samples can provide researchers with sufficient, rich data for relevant statistical analysis, the findings of which will not only be more reliable but generalizable. Furthermore, the involvement of additional groups consisting of external auditors or *shariah* review officers will provide greater insights into the understanding of the current auditing practices based on different perspectives.

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