

## An Analysis of Shari'ah Audit Practices in Islamic Banks in Malaysia

(Analisis Amalan Audit Shari'ah di Bank-bank Islam di Malaysia)

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### ABSTRACT

According to the Shari'ah Governance Framework (Bank Negara Malaysia 2011), each Islamic bank and Islamic financial institution in Malaysia is required to establish the Shari'ah audit function. The Shari'ah audit function, according to the Framework, is instituted in order to provide reasonable assurance and to ensure an effective internal control system for Shari'ah compliance. A review of the literature on this topic shows a lack of empirical studies that explain the Shari'ah audit practices in Islamic banks. This study examines the extent of Shari'ah audit practices in Islamic banks in Malaysia. The study employs survey questionnaires which were distributed to the Heads of Shari'ah audit, internal Shari'ah auditors, Shari'ah executives and members of the Shari'ah Committee of 16 Islamic banks in Malaysia. The study used the Exposure Draft of Internal Shari'ah Audit Framework (ISAF) issued by the International Shari'ah Research Academy (ISRA) as a benchmark to measure the extent of Shari'ah audit practices. The results of the study indicate that the majority of the Islamic banks have properly established the audit objectives, the governance structure, the competency requirements, the audit process, and the reporting requirements as part of their Shari'ah audit practices. However, some Islamic banks have not clearly spelled out the audit scope and the audit charter. The study also found that internal auditors, Shari'ah executives and members of the Shari'ah Committee mostly agreed on the importance of developing a proper structure for the Shari'ah audit function. In conclusion, the reasonably good Shari'ah audit practices present in Islamic banks are commendable and indicate a positive development in enhancing the integrity and the accountability of Islamic banks, especially in Malaysia.

Keywords: Auditing; Shari'ah audit; internal audit; Islamic banks

### ABSTRAK

Menurut Rangka Kerja Tadbir Urus Syariah (Bank Negara Malaysia 2011), setiap bank Islam dan institusi kewangan Islam di Malaysia perlu menubuhkan fungsi audit Syariah. Fungsi audit Syariah, menurut Rangka Kerja ini, dimulakan untuk memberi jaminan yang munasabah dan bagi memastikan sistem kawalan dalaman yang berkesan bagi pematuhan Syariah. Satu kajian literatur mengenai topik ini menunjukkan kekurangan kajian empirikal yang menerangkan amalan audit syariah di bank-bank Islam. Kajian ini melihat sejauh mana amalan audit syariah di bank-bank Islam di Malaysia. Kajian ini menggunakan soal selidik kajian yang telah diedarkan kepada ketua-ketua audit syariah, juruaudit Syariah dalaman, eksekutif Syariah dan ahli-ahli Jawatankuasa Syariah daripada 16 bank-bank Islam di Malaysia. Kajian ini menggunakan Draf Dedahan Rangka Kerja Audit Syariah Dalam Negeri yang dikeluarkan oleh International Shari'ah Research Academy (ISRA) sebagai penanda aras untuk mengukur sejauh mana amalan audit Syariah. Keputusan kajian menunjukkan bahawa majoriti daripada bank-bank Islam telah menetapkan objektif audit, struktur tadbir urus, keperluan kompetensi, proses audit, dan syarat-syarat pelaporan sebagai sebahagian daripada amalan audit syariah mereka. Walau bagaimanapun, sesetengah bank-bank Islam tidak menyatakan dengan jelas skop audit dan piagam audit. Kajian ini juga mendapati bahawa juruaudit dalaman, eksekutif Syariah dan ahli-ahli Jawatankuasa Syariah kebanyakannya bersetuju mengenai kepentingan membangunkan struktur yang seragam untuk fungsi audit Syariah. Kesimpulannya, amalan audit Syariah yang agak baik di dalam bank-bank Islam adalah terpuji dan menunjukkan satu perkembangan positif dalam meningkatkan integriti dan akauntabiliti dalam bank-bank Islam, terutamanya di Malaysia.

Kata kunci: Audit; audit Syariah; audit dalaman; bank Islam

### INTRODUCTION

The growth of Islamic banking and financial institutions in Malaysia began in 1969 with the establishment of the Pilgrim Fund Board or 'Tabung Haji' as the first Islamic savings institution. Later, in 1983, Bank Islam Malaysia Berhad (BIMB) was established as the first Islamic bank

in Malaysia (International Shari'ah Research Academy (ISRA) 2011b). This milestone achievement paved the way for the establishment of other full-fledged Islamic banks. In addition, conventional banks were permitted to set up Islamic banking subsidiaries. These Islamic banks are mandated to operate according to Shari'ah principles. This is a fundamental requirement as stakeholders participating

in Islamic banking activities expect more from Islamic banks (IBs), especially in terms of Shari'ah compliance.

In Malaysia, Islamic banks are required by the Shari'ah Governance Framework (SGF) to establish the Shari'ah audit function to provide the assurances for Shari'ah compliance in Islamic banking operations (Bank Negara Malaysia 2011). Currently, Bank Negara Malaysia (BNM) has yet to establish and enforce the Shari'ah audit framework as a standard guideline for all IBs in Malaysia. Little is known in terms of the current practice of Shari'ah audit in IBs and there are a number of challenges in Shari'ah audit practices (Abdul Rahim 2011). This is because each IB may have practised Shari'ah audit using its own auditing guideline or a modified conventional internal audit framework. Another challenge may arise in terms of gathering audit evidence, conducting a systematic Shari'ah audit program and producing an independent internal Shari'ah audit (Abdul Rahim 2008). The integrity of internal Shari'ah auditors can also be questioned by the stakeholders if they are not independent in expressing their opinions towards the Shari'ah compliant activities in IBs (Nawal et al. 2009). So far, previous research only examined the needs and challenges of Shari'ah audit practices.

Hence, the objective of this study is to empirically examine the extent to which IB's in Malaysia adopt Shari'ah audit practices. The study is unique as it adopts the Exposure Draft of Internal Shari'ah Audit Framework (ISAF) (ISRA 2011a) as the benchmark to examine the extent of the audit scope, the audit objectives, the governance structure, the audit charter, the competency of internal Shari'ah auditors, the audit process and the reporting requirements practiced by the sampled IBs. The study measures the extent of practices as compared to the proposed framework. The study examines the views of the internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members on the functions of the Shari'ah audit in IBs. This study also examines the perceptions of respondents who are directly and indirectly involved with Shari'ah audit practices in IBs. The views of Shari'ah Committee members are also examined. The findings on the current practice of Shari'ah audit in IBs from the Islamic banking practitioners provide an urgent call for the policy makers to consider establishing the Shari'ah audit framework as a standard guideline for IBs to effectively perform Shari'ah audit function. The function of Shari'ah audit in IBs is critical in enhancing the integrity of IBs and increase the confidence of the stakeholders of the Islamic banking operations.

#### SHARI'AH AUDIT: A REVIEW OF LITERATURE

Stakeholders need assurances on the integrity of Islamic banks that their operations and activities are Shari'ah compliant. Abdul Rahim (2011) argued that enhancing integrity is crucial for all Islamic Financial Institutions (IFIs) as the need is not only to pursue ethical finance, but

more importantly, to ensure their operational and business activities comply with Shari'ah principles. More than that, the financial performance, stability and ability of IFIs to provide intermediate resources depends on the integrity and confidence of stakeholders. The stakeholders who have invested in IBs are interested to ensure that their investment has been ventured faithfully into a Shari'ah compliant business (Graiss & Pellegrini 2006).

Shari'ah principles are the cornerstone of Islamic banking products, operations and services. Hence, Bhambra (2007) argued that the integrity and confidence of stakeholders would be seriously undermined if stakeholders discovered that their investment portfolios are not Shari'ah compliant. Therefore, to provide such assurances of integrity, regulators argued that there is a need for the internal Shari'ah audit practices to co-exist with Shari'ah controls. Through the Shari'ah systems and controls, the rulings of Shari'ah Committee could be disseminated within the financial institutions together with the Shari'ah audit requirements. Implementing Shari'ah audit offers independent monitoring and control that assist towards ensuring the integrity of IFIs. As regulated in the new Islamic Financial Services Act 2013, actions will be taken if the financial institutions do not meet the Shari'ah requirements (Bank Negara Malaysia 2013).

In addition, the Muslim public seeks assurances that all Islamic banking operations are in line with Shari'ah principles. Reasonable assurance of Shari'ah compliance is required through the opinions expressed by the internal Shari'ah auditors as derived from the audit process. Abdul Rahim (2008) argued that Shari'ah audit is a process of accumulating and evaluating evidence to determine and report on the degree of correspondence between information and established criteria for Shari'ah compliance purposes. Shari'ah auditors are the independent and competent person who will conduct the assurance process in both objective (financial information such as profit distribution) and subjective information (Shari'ah information) of IFIs. This information should be given in a verifiable form and some standards to help auditors throughout the auditing process (Abdul Rahim 2011).

In general, financial institutions play the role as financial intermediaries that move funds from the lender-saver who have surplus sources of funds to the borrower-spender who will use the funds for investment (Mishkin & Eakins 2009). The success of financial institutions depends on their ability to earn public trust, primarily from depositors and investors (El-Din 2004). Shareholders and investors ultimately look towards the ability of banks to achieve its financial objectives. For the IBs, there are additional objectives that need to be achieved, namely to meet both the Shari'ah and the financial objectives. In this case, the IBs exist to ensure that the entity is continuously operating within the framework of Shari'ah. The stakeholders and users of financial reports are more concerned to see the performance of IBs in promoting the well-being of people (Chapra 2008) and achieving the

socio-economic objectives of the society (Shahul Hameed 2005).

Past studies have shown that the lack of internal Shari'ah audit practices in Islamic banks is mainly due to the lack of understanding among internal Shari'ah auditors over the ways to perform a Shari'ah audit (Yazkhiruni & Nurmazilah 2012), and due to the absence of the internal Shari'ah audit framework (Sheila Ainon 2013). Although the Accounting and Auditing Organisations for Islamic Financial Institutions (AAOIFI) has issued the Auditing Standard for Islamic Financial Institutions No.1, this auditing standard is not a mandatory requirement for IFIs in Malaysia. Furthermore, BNM has yet to issue a specific Shari'ah audit framework that serves as a standard guideline.

A review of past studies indicates the lack of assurance process in enhancing the confidence of stakeholders of Islamic banks' Shari'ah compliance. IBs are also facing the risk of Shari'ah non-compliance, which will affect their credibility as an Islamic bank in terms of its compliance towards the rules and principles of Shari'ah (Nik Shahrizal 2012). The study acknowledges the importance and need for the Shari'ah audit to enhance the stakeholders' value and confidence in terms of the stability and financial performance of IFIs (Abdul Rahim 2008). In the context of religious legitimacy, scholars advocate the need for Shari'ah audit as a mode of assurance that the operations of IFIs are indeed Shari'ah compliant (Syed Alwi 2009), to ensure the right and proper conduct of its Shari'ah compliant activities (Nawal et al. 2009), to assess the procedures of each of its products to ensure its compliance with Shari'ah principles (Zurina et al. 2010), and to check the soundness of its internal control system (Zurina & Supiah 2010).

The internal audit offers assurances concerning the effectiveness of the internal control system in the IBs, whereas an internal Shari'ah audit offers additional criteria for assurances on matters pertaining to Shari'ah compliance (Roszaini 2010). The assurances afforded by means of a Shari'ah audit are not only restricted to the products offered by IBs, it also constitutes a controlling mechanism in terms of the process, procedures, organisational structure, operations, and the people and the environment of IFIs (Syed Alwi 2009). Internal Shari'ah audits are needed because the current internal audit does not intend to provide reasonable assurances that their Islamic banking activities are Shari'ah compliant, thus failing to meet the needs of stakeholders (Roszaini 2010).

Previous studies on Shari'ah audit have examined the needs and challenges (Abdul Rahim 2008), perceptions of academicians and practitioners towards Shari'ah audit (Ratna 2008) and audit framework for Shari'ah compliance (Zurina et al. 2010). A few studies on the Shari'ah audit practices in Islamic financial institutions in Malaysia have focused on the scope, competency, working practices and current framework used to perform Shari'ah audit (Nawal et al. 2009; Nik Shahrizal 2012; Yazkhiruni

& Nurmazilah 2012). Recent research in Shari'ah audit have examined the independence and competency quality to develop human capital in Shari'ah audit (Zurina et al. 2013) and the need to establish the professional institutions to produce qualified Shari'ah accountants and auditors (Syed Faiq & Shahul Hameed 2014).

As part of the corporate governance mechanism, the Shari'ah audit is needed to increase the confidence of stakeholders who will demand assurances of Shari'ah compliance in Islamic banking activities (Abdul Rahim 2008). External financial auditors, internal auditors and the Shari'ah unit must work together with the Shari'ah advisors to achieve the above needs (Abdul Rahim 2008). Nawal et al. (2009) argued that auditing for IBs needs to be performed in a different framework from conventional auditing. Since the external Shari'ah audit is not made mandatory by the regulators in Malaysia, majority of the IBs conduct the internal Shari'ah audit to review whether the financial activities comply with Shari'ah principles (Zurina et al. 2010).

Currently, the Islamic financial industry does not currently fully and systematically perform Shari'ah audit practices (Abdul Rahim 2011). Therefore, there is a crucial need to examine the Shari'ah audit practices in Islamic banks in Malaysia to enhance the level of integrity and confidence among stakeholders. Previous study done on the actual practices of Shari'ah audit in IFIs in Malaysia found lack of practices in terms of the framework, scope, qualification and independence (Nawal et al. 2009). However, limited research performed on the extent of Shari'ah audit practices. The Shari'ah audit is normally performed within the internal audit division in the IBs together with the current internal audit practices. After two years of the requirement in the Shari'ah Governance Framework to establish the Shari'ah audit function in Islamic banks, the study examines the extent to which each of the sampled IBs perform the Shari'ah audit in the absence of a Shari'ah audit framework in Malaysia. The research examines the Shari'ah audit practices in IBs using the Exposure Draft of Internal Shari'ah Audit Framework (ISAF) (ISRA 2011a) as a benchmark. This Exposure Draft serves as a general criteria and checklists to measure the extent of Shari'ah audit practices.

#### EXPOSURE DRAFT OF INTERNAL SHARI'AH AUDIT FRAMEWORK

Recently, the International Shari'ah Research Academy (ISRA) and Bank Negara Malaysia (BNM) initiated the effort to develop a Shari'ah audit framework. As IBs do not currently fully and systematically practice the Shari'ah audit, this internal Shari'ah audit framework aims to help Islamic banks and financial institutions properly conduct a Shari'ah audit (Abdul Rahim 2011). In this case, ISRA has produced the Exposure Draft of the Internal Shari'ah Audit Framework (ISAF) (ISRA 2011a) which covers the overall aspects of Shari'ah audit guidelines such as audit scope, audit objectives, audit and governance, audit



charter, competency of internal Shari'ah auditors, the audit process and reporting requirements (International Shari'ah Research Academy (ISRA) 2011a).

Shari'ah audit is needed to enhance the confidence of stakeholders that Islamic banking activities are Shari'ah compliant and to provide assurance on the internal control system for Shari'ah compliance as outlined by the SGF (Bank Negara Malaysia 2011). Therefore, this Exposure Draft of ISAF (ISRA 2011a) helps to provide a systematic and guided approach for the IBs to implement the Shari'ah audit effectively together with other functions in the Shari'ah governance process such as the Shari'ah risk management, Shari'ah review and Shari'ah research function.

*Audit Scope* In the first section, the Exposure Draft of ISAF (ISRA 2011a) detailed the scope of the internal Shari'ah audit to be performed by the internal Shari'ah auditors. As outlined by the Shari'ah Governance Framework, the scope of the internal Shari'ah audit covers the audit of financial statements, compliance audit on organisational structure, people, process and information technology application systems and the review of the Shari'ah governance process (International Shari'ah Research Academy (ISRA) 2011a). The audit of financial statements is essential so that IBs can ensure that "the transactions are recognised, measured and reported accurately to reflect the requirements of the Shari'ah contracts" (Abdul Rahim 2011: 139). The proper accounting and reporting of the transactions for the Shari'ah contracts and appropriate accounting information system for Islamic banking activities are required so that the financial statement does not include transactions which could lead to Shari'ah non-compliance. An internal Shari'ah audit on organisational structure and people is performed to ensure effective governance structure of the IBs in order to establish the four functions for Shari'ah compliance i.e. Shari'ah review, Shari'ah audit, Shari'ah risk management and Shari'ah research.

IBs need to be assured that the institutions are viable to undertake Islamic banking activities and operations with its qualified staff who have adequate knowledge of Shari'ah (Abdul Rahim 2011). Shari'ah audit practices need a specific scope of internal Shari'ah audit in the framework so that the qualified internal Shari'ah auditors may have a clear understanding to provide the reasonable assurance that the internal control system of IBs are Shari'ah compliant.

*Audit Objectives* According to the SGF, the objective of the Shari'ah audit function is "to ensure a sound and effective internal control system for Shari'ah compliance" (Bank Negara Malaysia 2011: 23). In that respect, the Exposure Draft of ISAF (ISRA 2011a: 11) has included the objective of the internal Shari'ah audit which is "to provide independent assessment and reasonable assurance of the Shari'ah compliance in Islamic banking activities including the internal control system" within the framework. Abdul Rahim (2011) argued that the primary

aim of the internal Shari'ah audit is to ensure that the management performs their responsibilities that Islamic banking activities are conducted based on Shari'ah rulings. With this objective, internal Shari'ah auditors can have a clear direction in determining and performing the internal Shari'ah audit practices.

*Audit and Governance* As the Shari'ah audit function is an integral part of the SGF, it is essential to ensure that IBs establish an effective structure and governance process in performing Islamic banking operations. The Exposure Draft of ISAF (ISRA 2011a) clearly outlines the internal Shari'ah audit and governance section to ensure that the Shari'ah audit function is established within the internal audit division. In addition, the Shari'ah audit function needs to report to the Board through the Board Audit Committee and will be overseen by the Shari'ah Committee members. To perform an effective internal Shari'ah audit, IBs need to have a dedicated Shari'ah unit which is independent from the management (Abdul Rahim 2011).

Abdul Rahim (2011) argued that IBs need to consider their human resource policy, the costs and size of operations before establishing a dedicated unit for the internal Shari'ah auditors. The dedicated unit for the internal Shari'ah audit should consist of qualified and competent staff to perform Shari'ah audit practices. In addition, good cooperation and understanding as business partners rather than auditors is needed between all units in IBs to achieve an effective and efficient implementation of the Shari'ah audit function.

*Audit Charter* The Exposure Draft of ISAF (ISRA 2011a) outlines the audit charter which establishes the internal Shari'ah audit position within the IBs. The audit charter addresses six main components such as the nature of the internal Shari'ah audit, internal audit objectives, scope of internal Shari'ah audit work, responsibilities, and the authorities and independence of internal Shari'ah auditors. Abdul Rahim (2011) argued that the Shari'ah audit charter will indicate clear planning, implementation and reporting line for the internal Shari'ah auditors. The internal Shari'ah audit plan shall be communicated to the Shari'ah Committee members. Sheila Aionon (2011) added that a Shari'ah-specific audit charter should align the common understanding on the Shari'ah mission and IB's vision among the internal Shari'ah auditors.

*Competency of Internal Shari'ah Auditors* Meanwhile, the Shari'ah Governance Framework (SGF) requires Shari'ah audit function to be performed by the internal Shari'ah auditors who have adequate Shari'ah knowledge (Bank Negara Malaysia 2011). Thus, competency indicates an important measure in Shari'ah audit practices. The Exposure Draft of ISAF (ISRA 2011a) includes the competency of internal Shari'ah auditors as the next section in the framework. The principle outlines that "internal Shari'ah auditors shall be competent in both

auditing knowledge, skills and Shari'ah knowledge relevant to the IFIs" (International Shariah Research Academy (ISRA) 2011a: 14). It is important for the internal Shari'ah auditors to be proficient in applying internal auditing standards, accounting principles, understand the management principles and to have adequate knowledge in Shari'ah.

The Exposure Draft of ISAF (ISRA 2011a) specifies that the knowledge on Shari'ah for the internal Shari'ah auditors may include fiqh muamalat, sources of Shari'ah, principles of Islamic financial contracts and its prohibited elements and the relevant Islamic financial contracts to IBs in Malaysia. It is important for the internal Shari'ah auditors to be able to conduct appropriate audit tests in line with the Shari'ah audit objectives and scope (Abdul Rahim 2011). The internal Shari'ah auditors need to be well versed in the Islamic principles of Islamic financial contracts and understand the basic activities of IBs.

**Audit Process** The internal Shari'ah audit process includes comprehensive audit processes such as the planning, examination and reporting which can be obtained by relevant and sufficient evidence for Shari'ah audit purposes. The Exposure Draft of ISAF (ISRA 2011a) outlines the essential matters in the internal Shari'ah audit process, the auditable areas, control effectiveness and adequacy of the Shari'ah risk management. The essential matters of the internal Shari'ah audit are the process to formulate an audit plan which includes auditable areas on Shari'ah compliance system, review and objectives, assess the adequacy of Shari'ah compliance review, implementing risk-based audit process, audit documentation in the audit programme and expresses the audit opinion that the internal Shari'ah control system of the IB is effective (International Shariah Research Academy (ISRA) 2011a).

The Exposure Draft of ISAF (ISRA 2011a) also specifies the auditable areas such as to understand management awareness and control procedures for adherence to Shari'ah, assess risk for any Shari'ah non-compliance risk in Islamic banking activities, audit of product manuals, agreements, contracts, standard operating procedures (SOPs), minutes of meetings and financial reports, communication with relevant personnel and to audit relevant transactions that were recorded. Internal Shari'ah auditors must be able to communicate directly to the management and have full access to all documents and audit evidence throughout the audit process (Abdul Rahim 2011). As part of an effective internal control, the internal Shari'ah audit process shall assist the IBs in terms of achieving the integrity of financial and operation information, ensure effectiveness of activities, safeguard the assets and ensure that the operations comply with the laws and regulations (International Shariah Research Academy (ISRA) 2011a). In terms of the Shari'ah risk management, the Exposure Draft of ISAF (ISRA 2011a) outlines that the internal Shari'ah audit process will provide the assurance related to the identified Shari'ah

non-compliance risk, risk mitigation activities and the current monitoring activities.

**Reporting Requirements** Finally, the Exposure Draft of ISAF (ISRA 2011a) specifies the reporting requirements to properly communicate the audit findings and recommend rectifications to the Board Audit Committee and the Shari'ah Committee members. The internal Shari'ah audit report will provide "the findings on Shari'ah non-compliance, assess the recurrence of non-compliance, recommend corrective actions, suggest timelines for rectifications and to monitor the rectification progress. Internal Shari'ah auditors should have an "independent mental attitude" to express their opinion in the audit report so that users and stakeholders will be confident that Islamic banking operations are assured of Shari'ah compliance (Abdul Rahim 2011). High level of independence in the audit report is also needed to enhance the integrity of the IBs. The internal Shari'ah audit report will provide reasonable assurance on the observations, assessment of systems and Shari'ah non-compliance risks and control. The Exposure Draft of ISAF (ISRA 2011a) remains on the drawing board and has yet to be enforced by BNM. Without a proper guideline, it is difficult for IBs to ensure Shari'ah compliance in line with the current Shari'ah governance arrangements.

## METHODOLOGY

The study employs a survey questionnaire to analyse the extent of Shari'ah audit practices in Islamic banks in Malaysia. In order to develop the questionnaires, the research constructs the questions using the Exposure Draft of ISAF (ISRA 2011a) as the base guideline. The survey questionnaires are divided into seven (7) sections according to the Exposure Draft of ISAF to determine the implementation of internal Shari'ah audit practices in terms of the audit scope, audit objectives, audit and governance, audit charter, competency of auditors, audit process and reporting requirements.

The study employs two different sets of survey questionnaires for two different groups of respondents. The first set of survey questionnaires were distributed to the Head of Shari'ah audit to determine the extent of Shari'ah audit practices. The levels of agreement provided by the respondents were measured by the percentages of each level of agreement (Yes or No). Meanwhile, the second set of survey questionnaires were distributed to the group of internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members to examine the views on the function of Shari'ah audit in IBs in Malaysia. The respondents' perception from this group of respondents were measured using the 5-point Likert scale (1=strongly disagree to 5=strongly agree). Data collected from the survey questionnaires were analysed using SPSS to determine the extent of Shari'ah audit practices in Islamic banks.

The research adopts purposive sampling to choose only one respected individual as the representative from each IB to describe the current practice of the internal Shari'ah audit in their respective IB. This is because when measuring the extent of practices, only one reliable and accurate response is needed to portray the current practice of the Shari'ah audit in each IB in Malaysia. To choose the most appropriate respondents to account for the extent of Shari'ah audit practices using purposive sampling, the study notes that each IB in Malaysia is required to establish the Shari'ah audit function as part of the SGF (Bank Negara Malaysia 2011).

The Shari'ah audit function in each IB should have one key person such as the Head of Shari'ah audit who is accountable for the Shari'ah audit function with the rest of the internal Shari'ah auditors. The Head of Shari'ah audit is the person who is at the managerial position to coordinate and handle strategic issues related to the Shari'ah audit practices in the respective IB. The head of Shari'ah audit is also able to clarify the structure used by the IBs to practise the Shari'ah audit in the absence of a guideline issued by BNM. This important person is surely aware of the scope, objectives, system and the process in the Shari'ah audit as practised by the Islamic bank. Since there are ten local and six foreign IBs in Malaysia, the research obtained all 16 responses from the heads of the internal and/or Shari'ah audit in each bank.

Meanwhile, the study adopts the stratified random sampling method to choose the internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members to examine their views on the functions of Shari'ah audit in IBs in Malaysia. This sampling method is chosen because it enables the research to increase the efficiency of the collected data. Moreover, the different subgroups of elements are expected to come up with different parameters on a variable (Sekaran 2003).

The study divides the target samples according to three groups i.e. the internal Shari'ah auditors, the Shari'ah executives and the Shari'ah Committee members. The study also takes random selection of five (5) people from each group in each of the 16 Islamic banks (IBs). These respondents are considered a reliable sample to provide their views on the function of the Shari'ah audit in IBs. The group of internal Shari'ah auditors was chosen due to the fact that they are directly involved with the ground practices of the internal Shari'ah audit in IBs. Therefore, they are considered representative samples to provide opinions on internal Shari'ah audit practices. Meanwhile, the study chooses the group of Shari'ah executives and the group of Shari'ah Committee members for their views on the function of Shari'ah audit and their degree of acceptance of the components practised by the Shari'ah audit function. Although Shari'ah executives are not directly involved in the Shari'ah audit practices, the internal Shari'ah auditors can engage the work together with the Shari'ah executives within their respective scope of work as long as the objectivity of Shari'ah has not been threatened (Bank Negara Malaysia 2011). Meanwhile,

the Shari'ah Committee members are the most crucial external parties to the IBs who perform an oversight role to the Shari'ah audit function in Islamic banks. Internal Shari'ah auditors will normally consult and report Shari'ah issues that might arise during the audit processes.

Table 1 summarises the distribution and responses received from the survey questionnaires. Out of the total survey questionnaires that were distributed, only 97 completed and one incomplete survey questionnaires were returned by the respondents. The percentage level of agreement on the extent of Shari'ah audit practices answered by the Head of Shari'ah audit were analysed over the total of 9 completed survey questionnaires received. Meanwhile, the views on the functions of Shari'ah audit by the internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members were analysed based on the total completed survey questionnaires received for each group of respondents.

TABLE 1. Distribution and responses received from the survey questionnaire

Subjects	Distribution	Received	Usable responses	Usable responses rate (%)
<i>Survey questionnaires (Set 1)</i>				
Head of Shari'ah audit	16	9	9	56.25%
<i>Survey questionnaires (Set 2)</i>				
Internal Shari'ah auditors	80	32	32	40.0%
Shariah executives	80	38	38	47.5%
Shari'ah Committee members	80	18	18	22.5%
Incomplete / Unusable		1		
OVERALL	256	98	97	37.89%

## FINDINGS AND DISCUSSIONS

### CURRENT STRUCTURE OF SHARI'AH AUDIT FRAMEWORK AND FREQUENCY OF SHARI'AH AUDIT PRACTICES

The structure and frequency of Shari'ah audit practices in IBs is important because it shows the current framework practised in each IB from the view of respondents. From Table 2, the number of respondents in each group of internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members are represented by N. The percentages were calculated according to the total N figure for each group of respondents. The research found some variances in the respondents' view on the current structure of Shari'ah audit in their respective IBs. The majority of respondents (40.2%) viewed that their bank has developed

its own framework of auditing from Islamic perspectives while 38.1% of total respondents viewed that IBs relied heavily on the conventional auditing framework with few adjustments. Individually, about 48.4% of internal Shari'ah auditors and 55.6% of the Heads of Shari'ah audit viewed that their IBs have relied heavily on the adapted conventional internal auditing framework.

The study indicates that many IBs were using an unsuitable auditing framework to perform the Shari'ah audit. This is because internal Shari'ah auditors currently perform the Shari'ah audit using the modified IPPF established by IIA in terms of the scope and objectives of the Shari'ah audit. Conventional internal auditing only provides the objective assurance on the internal control system of the IBs (International Institute of Internal Auditors (IIA) 2011). However, internal Shari'ah audit practices require broader dimensions, which include the competency of Islamic banking employees, and the governance structures and policies in place to ensure Shari'ah compliance.

Stakeholders need to be assured that all Islamic banking activities and operations are Shari'ah compliant and not only the products. Therefore, the Shari'ah audit

needs to be performed with a separate Shari'ah audit framework. Otherwise, stakeholders such as customers and shareholders may not appreciate the distinctive features of Islamic banking operations. The current Shari'ah audit practices using the conventional internal auditing framework may not be effective and could affect the reliability of the Shari'ah audit findings.

The study also found consistent perspectives from the respondents in the sense that 68.0% of the total respondents viewed that the internal Shari'ah audit should be conducted throughout the financial year. The consistent view by the internal Shari'ah auditors (89.7%), Shari'ah executives (66.7%), Shari'ah Committee members (61.1%) and Head of Shari'ah audit (55.6%) are highlighted in Table 2. The study argues that there is an increasing level of awareness on the importance of providing consistent assurance for Shari'ah compliance throughout the financial year. Some internal Shari'ah auditors also viewed that due to high risk banking activities, Shari'ah audit needs to be conducted throughout the year. SGF requires IBs to perform Shari'ah audit at least once a year on critical and risky areas (Bank Negara Malaysia 2011).

TABLE 2. Current structure and frequency of conducting shari'ah audit in Islamic banks

	Internal Shari'ah auditors		Shari'ah Executives		Shari'ah Committee Members		Head of Shari'ah audit		Total	
	N	%	N	%	N	%	N	%	N	%
<i>Current structure of Shari'ah audit:</i>										
Same as conventional auditing framework	4	12.9	0	0	0	0	1	11.1	5	5.2
Relied heavily on the conventional auditing framework with few adjustments	15	48.4	12	36.4	5	29.4	5	55.6	37	38.1
Have their own framework of auditing from Islamic perspective	11	35.5	16	48.5	9	52.9	3	33.3	39	40.2
Not aware of what framework they use	1	3.2	5	15.2	3	17.6	0	0	9	9.3
<i>Incomplete</i>										
Total	31	100	33	100	17	100	9	100	97	100
<i>Frequency of conducting internal Shari'ah audit:</i>										
Throughout the financial year	26	89.7	24	66.7	11	61.1	5	55.6	66	68.0
Ad-hoc basis upon request of the Shari'ah Committee, Board of Directors, management and/or regulators	0	0	4	11.1	2	11.1	0	22.2	6	6.2
At the end of the financial year	2	6.9	6	16.7	2	11.1	2	11.1	12	12.4
Others	1	3.4	2	5.6	3	16.7	1	11.1	7	7.2
<i>Incomplete</i>										
Total	29	100	36	100	18	100	8	100	97	100

Note: N = number of respondents

THE EXTENT OF SHARI'AH AUDIT PRACTICES

The extent of Shari'ah audit practices in Islamic banks in Malaysia were analysed in terms of the audit scope, audit objectives, governance structure, audit charter, competency of internal Shari'ah auditors, audit process and reporting requirements. The survey questionnaires were responded to by the Heads of Shari'ah audit and

concerned the current practice of Shari'ah audit in their respective IB. The findings are outlined in Table 3 according to the two types of IBs. The number of IBs responded to the survey questionnaires are represented by the N figure and the percentages were calculated over the total N figure for each type of IBs. In total, nine out of 16 IBs responded to the survey questionnaire of which six



TABLE 3. Summary of shari'ah audit practices

No.	Sections	Full-fledged		Islamic Subsidiaries		Overall	
		N	%	N	%	N	%
1.	Audit Scope						
1.1.	<i>Audit of the financial statements of the IFI.</i>	3	100.0	2	33.3	5	55.5
1.2.	<i>Compliance audit on organisational structure, people, process and information technology applications systems</i>	3	100.0	6	100.0	9	100.0
	The need for Shari'ah Committee to review the human resource policy.	2	66.7	2	33.3	4	44.4
	Accounting information system.	3	100.0	2	33.3	5	55.5
1.3.	<i>Review of adequacy of the Shari'ah governance process.</i>	3	100.0	6	100.0	9	100.0
2.	Audit objectives	3	100.0	6	100.0	9	100.0
3.	Audit & Governance	3	100.0	6	100.0	9	100.0
4.	Audit Charter	3	100.0	4	66.7	7	77.8
	The nature of internal Shari'ah auditing.	3	100.0	3	50.0	6	66.7
5.	Competency of internal Shari'ah auditors	3	100.0	5	100.0	8	100.0
6.	Audit process	3	100.0	6	100.0	9	100.0
7.	Reporting Requirements	3	100.0	6	100.0	9	100.0

Note: N = number of respondents

of them are from Islamic subsidiaries and three are from the full-fledged IBs.

**Audit Scope** The study found that only 55.5% of the respondents have established audit of financial statements as part of their internal Shari'ah audit. The practice mostly comes from the full-fledged IBs. There are four Islamic banking subsidiaries that excluded the audit of financial statements as part of their audit scope. This may contribute to operational risk due to the improper treatment of accounting transactions. It may be possible that the preparation of the financial statements includes non-halal income and Shari'ah non-compliant financial activities. There could be misunderstanding of including financial statements as part of the Shari'ah audit scope as many may perceive financial statements should be audited by external financial auditors instead.

Internal Shari'ah audit practices do not execute the external audit's work, but check the financial statements for any non-conformity of the Shari'ah. The role of internal Shari'ah auditors is to ensure the adequacy, effectiveness and efficiency of the internal control system to prevent any Shari'ah non-compliance issues. Therefore, throughout the process, internal Shari'ah auditors can help IBs with the reporting or recognition of any non-Shari'ah information in the financial statements. External auditors are not trained to check for Shari'ah compliance in the financial statement audit. As financial statements account for major financial operations and IBs are required to operate according to the Shari'ah principles (Mustafa et al. 2012), hence, it is essential for the internal Shari'ah audit to be performed on the financial statement of the IBs.

Table 3 shows that almost all respondents have established Shari'ah compliance audit on organisational

structure and IB processes, branches and front offices as part of their Shari'ah audit scope. The study argues that IBs may have realised the importance of the Shari'ah review, Shari'ah audit, Shari'ah risk management and Shari'ah research function in establishing an effective governance structure and ensure Shari'ah compliance in their activities.

However, the study found that only 44.4% of IBs consider human resource policy as part of the scope of the Shari'ah audit. Other respondents may not appreciate the importance of human resource policy, which could affect the image and integrity of IBs. IBs will face reputational and Shari'ah risk if their employees are not competent to perform the Islamic banking activities and if the employees do not practise Islamic code of conduct to reflect the image of IBs. Human resource policy includes the procedure to appoint new staff and trainings for employees. Mustafa et al. (2012) argued that the human resource policy for IBs should include the dress code of employees from the Shari'ah point of view. Hence, there is a need for Shari'ah Committee members to review the human resource policy and not only review the Shari'ah compliant aspects of the Islamic banking products and procedures. The Shari'ah Committee members should issue Shari'ah resolutions on the human resource policy. This is important to increase the employees' knowledge on the distinctive features, objective and operations of IBs compared to conventional banking.

On the other hand, the study found that only 55.5% of the IBs include accounting information systems and other schemes such as financing, trade finance and remittance system as part of the audit scope. Some IBs did not consider accounting information system as part of the Shari'ah audit scope because IBs normally focus



on providing Shari'ah compliant products but fail to recognise the importance of recording the Islamic banking transactions using a separate accounting system from that of conventional banking. Therefore, IBs will face Shari'ah and operational risks if the internal Shari'ah auditors do not ensure that the accounting information systems are Shari'ah compliant. Mustafa et al. (2012) argued that the financial transaction derived from the accounting system should reflect the Shari'ah applications in the IFIs. This will increase the level of stakeholders' confidence that the Islamic banking transactions are treated carefully using the Shari'ah compliant system.

Interestingly, all respondents reviewed the adequacy of the Shari'ah governance process in their scope of Shari'ah audit. No issue can be raised as almost all respondents have audited the role and functions of the Board, management and Shari'ah Committee. The IBs have also checked that the formal reporting channel on Shari'ah matters is carried out effectively and on a timely manner.

*Audit Objectives* Audit objectives includes a clear and implementation of effective internal control objectives, establish complete standard operation procedures (SOPs), set the reporting timeline and establish reliable information technology application system as part of their Shari'ah audit objectives. The study found that all respondents have established the above matters as part of the Shari'ah audit objectives. This shows that the banks have understood the importance of including these elements to provide independent assessment and objective assurance for Islamic banking activities.

*Audit and Governance* Audit and governance includes the establishment of an independent internal audit division and have a proper communication and consultation with the Board Audit Committee and Shari'ah Committee members. The study found that 100% of respondents have established the above matters to establish an effective structure governance process in their respective IB. The findings showed that all IBs have established the Shari'ah audit function as required by the SGF. In addition, the banks have ensured the independence of the internal audit division from management and the Shari'ah department as well as its accountability to the Board through the Board Audit Committee. Besides that, the banks have ensured that internal audit division consults Shari'ah Committee members in planning, examining and reporting of Shari'ah audit. This shows that most respondents have understood the crucial needs for an efficient audit and governance in the structure of their IBs.

*Audit Charter* Audit charter includes the nature, objectives and scope of internal Shari'ah audit as well as the responsibilities, authorities and independence of internal Shari'ah auditors in their audit charter. Here, the study discovered that 77.8% of respondents, mostly in full-fledged IBs, have established an audit charter as part of their Shari'ah audit function. The findings show that

the majority of the IBs agree on the need to have proper planning, execution and reporting of the Shari'ah audit function. The banks have also included the objectives, scope, responsibilities, authority as well as independence of internal Shari'ah auditors in the audit charter. This audit charter constitutes concrete elements for the bank to practice the Shari'ah audit.

The result shows that only 50% of respondents from Islamic subsidiaries have included the nature of internal Shari'ah auditing in the audit charter. The nature of internal Shari'ah auditing includes the need to have a separate Shari'ah audit plan and examination for the Shari'ah audit function. This low result shows that internal Shari'ah auditing work in Islamic subsidiaries is performed together with the group's internal audit in the IBs. However, the understanding of internal Shari'ah auditors on the distinctive features of the internal Shari'ah audit plan as compared to the conventional internal audit is lacking. The finding indicates that audit charter is well established by the full-fledged IBs. Islamic subsidiaries have not established the nature of internal Shari'ah auditing in the audit charter.

*Competency of Internal Shari'ah Auditor* Competency of internal Shari'ah auditor covers the skills, competencies and basic qualifications of internal Shari'ah auditors. The study found that nearly all respondents have established competency of the internal Shari'ah auditors as part of their Shari'ah audit practices. The finding of the study indicates that the IBs have ensured the proficiency of their internal Shari'ah auditors in applying internal auditing procedures, accounting and management principles, communication skills as well as the ability to construct appropriate audit tests in line with the audit objectives. PricewaterhouseCoopers (2011) suggested that IBs conduct more training to enhance the skills and knowledge of auditors in the Shari'ah-related audit risks and issues.

*Audit Process* Audit process includes the essential matters and auditable areas to be performed in the Shari'ah audit process such as the formulation of audit plan and assessment of Shari'ah compliance review. The study also examined to what extent Shari'ah audit process in IBs have included the review of governance system and the Shari'ah risk management process. The study found that nearly all respondents have established most of the Shari'ah audit processes outlined in the Exposure Draft of ISAF (ISRA 2011a). The banks have included auditable areas such as understanding of management awareness for adherence to Shari'ah, risk assessment for Shari'ah non-compliance risks and assessment of the adequacy of internal control systems. Other auditable areas such as audit of contracts, product manuals, standard operating procedures, reports, promotion and marketing materials have been implemented in the Shari'ah audit process.

*Reporting Requirements* Reporting requirements mean reporting of Shari'ah audit findings and the elements

included in the Shari'ah audit report. The findings indicate that nearly all IBs in the sample have established these reporting elements in the Shari'ah audit. The majority of IBs report the audit findings on any Shari'ah non-compliant issues and recommend the rectification, monitor the progress of improvements on any Shari'ah issues as well as communicating the result to the Board Audit Committee and Shari'ah Committee members.

#### VIEWS ON THE FUNCTION OF SHARI'AH AUDIT

The research evaluates the respondents' view on the function of the Shari'ah audit in IBs in terms of its audit scope, audit objectives, audit and governance, audit charter, competency of auditors, audit process and the reporting requirements. Table 4 outlines the summary of mean scores for each component for the function of the Shari'ah audit based on the three groups of respondents from the IBs.

TABLE 4. Summary of means scores for each component in the function of the Shari'ah audit

Designation	MEANS SCORES							
	Scope of Audit	Audit Objectives	Audit & Governance	Audit Charter	Competency of Auditors	Audit Process	Reporting Requirements	Total
Internal Shari'ah Auditor (N=32)	4.52	4.47	4.58	4.30	4.33	4.47	4.63	4.48
Shari'ah Executives (N=38)	4.49	4.54	4.60	4.44	4.42	4.46	4.68	4.49
Shari'ah Committee Members (N=18)	4.52	4.45	4.50	4.58	4.31	4.40	4.75	4.46
Total Means (N=88)	4.51	4.50	4.57	4.42	4.36	4.45	4.68	4.48
Kruskal-Wallis Test (Assym. Sig.)	0.915	0.693	0.412	0.428	0.385	0.879	0.892	0.737

Note: N = number of respondents

The finding indicates that the internal Shari'ah auditors who are directly related to the Shari'ah audit practices expressed the lowest mean score of 4.30 on their perspective towards the importance of audit charter. Only a few internal Shari'ah auditors have disagreed on the importance to include the nature of internal Shari'ah auditing as part of the audit charter. As most Shari'ah auditors are also the internal auditors, their understanding on the different objectives of Shari'ah audit may be lacking. This might be due to most of the internal Shari'ah auditors possess limited knowledge on Shari'ah to perform the Shari'ah audit. Therefore, they may not see the importance of having a dedicated unit of internal Shari'ah audit. IBs should ensure that internal Shari'ah auditors are proficient in both auditing and Shari'ah knowledge (Ratna 2008).

The study also found that Shari'ah Committee members, who are the most crucial external parties to the IBs, perceived the lowest mean score of 4.31 on their perspectives towards the importance of competency of internal Shari'ah auditors. Some Shari'ah Committee members may not appreciate the importance of skills in dealing with people and understanding of management principles as part of competency for internal Shari'ah auditors. Shari'ah Committee members may lack the understanding on the process of internal audit which requires knowledge of management and skills to deal with people. Good skills in dealing with people enable the internal Shari'ah auditors to communicate with all units and obtain access to full information to perform the

Shari'ah audit. It is important for IBs to provide training for the Shari'ah Committee members to understand the operations of Shari'ah audit practices.

The study also found that there is no significant difference between the views of internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members on the function of Shari'ah audit. The Kruskal-Wallis test revealed high significant value for the total components for the Shari'ah audit function (Sig. value of 0.737). According to Pallant (2011), if the Sig. value is less than or equal to 0.05, then there is a significant difference in the mean score between the group variables. Hence, the result indicates that respondents do not have any significant difference in their perspective towards the importance of the components for the Shari'ah audit function in IBs. The finding contradicts with the prior expectation that internal Shari'ah auditors may provide different views given the direct relation to the Shari'ah audit practices. This may be due to the implementation of the Shari'ah Governance Framework since 2011, which may have reduced the differences between the perspectives of respondents on the components of the Shari'ah audit function.

As a whole, the study argues that almost similar mean scores obtained in the findings were positively influenced by a good understanding of the Shari'ah Governance Framework requirements among the respondents. Most internal Shari'ah auditors, Shari'ah executives or Shari'ah Committee members appreciate the need for the Shari'ah audit function to enhance the degree of Shari'ah compliance in IBs. Stakeholders need to be

convinced by the proper practice of the Shari'ah audit in IBs. Ratna (2008) argued that a framework helps to ascertain the extent of Shari'ah compliance in IBs. With the implementation of a structured framework for the internal Shari'ah audit function, the internal control system of IBs can be ensured for Shari'ah compliance.

The study argues that there is a strong demand from Islamic banking practitioners to have a standard guideline for the Shari'ah audit function. As the Shari'ah Governance Framework provides a more coordinated and effective structure for the Shari'ah audit function, internal Shari'ah audit practices may help to ensure Shari'ah compliant of the internal control systems (Bank Negara Malaysia 2011). Internal Shari'ah audit practices are different from the conventional internal auditing in the IBs. Therefore, internal Shari'ah audit practices require a separate Shari'ah audit framework different from the conventional internal audit framework. The Shari'ah audit framework will provide a guideline for independent assessment of the internal Shari'ah audit performed by competent internal Shari'ah auditors. Moreover, a proper reporting requirement will assist the periodical assessment of the Shari'ah audit in IBs (Bank Negara Malaysia 2011).

The study also found that internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members have a good understanding of their duties as outlined by the SGF. Respondents agreed on the importance of audit and governance for the function of the Shari'ah audit to provide a standard monitoring system for Shari'ah compliances in IBs. In addition, respondents agreed on the importance of the competency of internal Shari'ah auditors to ensure that they understand the operations and objectives of IBs, which differ from conventional banking. This could help provide an inclusive direction for the board, Shari'ah Committee and management in IBs to perform their responsibility in ensuring Shari'ah compliance in their respective institution (Bank Negara Malaysia 2011). As SGF only provides general guidance for the IBs to comply with the requirements of the Shari'ah audit function, this framework may support the good governance structure and processes in the IBs.

Consequently, the study noted that the majority of the respondents highly supported that all the seven components in the function of Shari'ah audit should be carried out by the IBs. The proper implementation of a Shari'ah audit framework will complement the SGF to enable a check and balance in ensuring Shari'ah compliance. This will also contribute towards an effective implementation of internal Shari'ah audit practices. The study also found that it is important to develop a proper structure for the Shari'ah audit function in IBs.

#### CONCLUSIONS

This study is unique as it used the Exposure Draft of Internal Shari'ah Audit Framework (ISAF) issued by ISRA (2011a) as the benchmark to determine the extent

of Shari'ah audit practices in IBs in Malaysia. The study found that the extent of the current Shari'ah audit practices in IBs in Malaysia is highly acceptable after only two years of the requirement of the Shari'ah Governance Framework (SGF). The high acceptability of Shari'ah audit function indicates that the majority IBs in Malaysia have successfully established the audit objectives, the audit and governance, the competency requirements of internal Shari'ah auditors, the audit process and the reporting requirements in performing the Shari'ah audit.

The results of the study also indicate the inconsistent views of the respondents on the Shari'ah audit practices in terms of the audit scope and the audit charter. While nearly all full-fledged IBs have established most elements in the audit scope, three out of six Islamic subsidiaries have not considered the audit of financial statements, the need for Shari'ah Committee members to review human resource policy and the Shari'ah audit on the information technology application system. Despite the inconsistent findings in some elements of the Shari'ah audit practices, the result shows that Shari'ah audit practices have been carried out sufficiently by the IBs. The Shari'ah audit of financial statements in IBs, which includes investment and financing, has supported the view that the scope of Shari'ah audit should be more than just the Shari'ah compliance of products. The extent Shari'ah audit practices in IBs indicate a positive response by IBs to enhance their integrity and accountability.

Finally, Shari'ah audit practices in IBs have been performed at its own discretion using either modified conventional internal auditing framework or its own Shari'ah audit guidelines. Hence, the study indicates the need for a proper Shari'ah audit framework and guidelines in order to enhance the integrity and accountability of IBs. The positive feedback from the respondents provides a vital message for the regulatory agencies such as BNM in Malaysia to develop and to enforce a comprehensive Shari'ah audit framework for IBs.

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