

THE ROLE OF INTERNAL AUDITING IN ENSURING GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTION (IFI)

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ABSTRACT

Auditing in the Islamic framework has wider scope than the current practice of auditing due to the distinct worldviews and concepts (Hamid et.al., 1993; Haneef, 1997; Abdul Rahman, 2008) embedded in Islamic regulation known as 'shariah'. The two main issues are related to the shariah audit framework and the factors affecting their judgment of internal auditors while conducting audit of Islamic financial institutions. Shariah audit might simply be defined as an audit attestation for shariah compliance. In Malaysia, Central Bank of Malaysia (BNM) issued a guideline on the Shariah Governance Framework (SGF) 2010, which has specified that shariah audit should be conducted by internal auditors. However, little is known on what should be the practical model defining issues such as scope, extent, audit reporting, qualifications as well as current practices and understanding of shariah auditing in Islamic financial institutions. This study attempts to investigate current practice of shariah auditing among IFIs in Malaysia. Research data for this study is obtained from 5 semi structured interviews conducted with chief audit executive of IFIs. It is discovered that, the practices are still at development stage and need further improvement. For instance to increase the understanding of shariah auditing among internal auditors, enhance the shariah knowledge of internal auditors, standardization of shariah audit framework and providing general guidelines to design audit program for shariah auditing.

Field of Research: *Auditing, Internal auditing, Islamic auditing, Islamic banking and finance*

1. Introduction and Background of Study

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 developed in the area of Islamic economics and Islamic finance. However, much work is still needed in developing the conceptual principles of Islamic economics and Islamic finance in the areas of accounting and auditing. The need arises as a spin off from the development of Islamic financial institutions, which trigger significant changes and

demand from the public. Recent researches have shown an emerging concern with the interaction of business activity and Islam (Gambling & Karim, 1986; Abdel – Magid, 1981; Alam, 1991; Hamid *et.al.*, 1993; Mirza & Baydoun, 1999). Islam has recognized business activities can be part of *ibadah* (worship and obedience to Allah) if they are performed in accordance with the commands of Allah and the Islamic code of conduct (Ahmad, 1988). This can be interpreted in several of Quranic verses such as 2:30; 14:32-33 and 31:20). Therefore, Islam does not separated business or worldly activities as such.

In 1992, the Accounting and Auditing Organization for Islamic Bank and Financial Institutions (AAOIFI) was established. The main objective of its establishment is to fulfill the needs of Islamic banks and financial institutions. While, the Islamic banks have been established to assists Muslims and Islamic societies in investing their money in beneficial manner and consistent with the *shariah* principles which concerns on certain features such as prohibition of interest, profit sharing, avoidance of activities that Allah forbidden and societies interest. To achieve confidence and to attract the investors or depositors, the IFIs stems mainly from their compliance with all the *shariah* principles in their dealing and business activities. Such confidence however cannot be developed without several important measurements, one of which is the communication of relevant information to assists users in evaluating the bank's compliance with *shariah* principles and the attestation and assurance that their business is complying with all the *shariah* principles.

Therefore, the objective for financial accounting and auditing as explained by AAOIFI is to provide information, through periodic reports, about the entity's financial position, its results of operations and cash flows to assist users in making decisions. In addition, the objective of an audit of financial statement is to enable the auditor to express an opinion based on true and fair view as to whether the financial statements are prepared, in all material respects is in accordance with the *shariah* rules and principles. AAOIFI also stated that the objectives of financial reporting for Islamic banks and other banks should have differences mainly because of Islamic banks must comply with the principles and rules of *shariah* in all their financial and other dealing; the functions of Islamic banks are significantly different from those of traditional banks who have adopted the Western model of banking and the relationship between Islamic banks and their investors or depositors differs from the relationship of those who deal with traditional banks. It is very important to note that Islamic banks mobilize funds through investment accounts on the basis of Mudharabah, profit and loss sharing mechanism and deferred payments methods consistent with *shariah*.

Consistent with such development, research and study especially in the area of accounting and auditing is much in demand as it need to capture the effects on the compliance of Islamic beliefs on the operations of Islamic financial institutions within the Islamic framework or *shariah* principles. In particular, the incompatibility of many Western values and norms with Islamic practices requires explanations (Hamid *et.al.*, 1993; Mirza & Baydoun, 1999; Childs, 2002). Auditing in Islamic framework would have a wider scope than traditional auditing. In contemporary practice, the auditor is directly liable only to his client's who are the owner of the business being audited. He is not guided by religious principles, the quality of managerial decisions too are not his concerns. Therefore, the auditor is just responsible to give his opinion whether company's financial statement being prepared in accordance with accounting and auditing standards. In light of Islamic teaching, the role of auditor would assimilate some different approach and objective i.e. upholding *shariah* principles. *Shariah* audit might be simply defined as an audit attestation for *shariah* compliance. However, when elaborated to a complex and risky business of banking, the

definition needs to cover a wider aspect of the management of financial institutions. Among the issues are; how comprehensively we should define *shariah* audit?; What is the scope of *shariah* audit?; What makes *shariah* audit framework different from the conventional auditing framework?; What types of audit planning should we establish in order to uphold *shariah* principles?; Who are qualified to perform the task?; What are the factors affecting internal auditor's judgment while they performing *shariah* audit?;. These are among the questions that are yet to be resolved with regards to the *shariah* audit. As a results, the practices of *shariah* audit as well as the understanding of *shariah* audit, principles and factors that influence auditors while they perform judgment is little known and heterogeneous. We posit that it is not only *Shariah* Audit that we should look at but the internal audit of the whole IFIs.

In Malaysia for example, the establishment of *shariah* committee is compulsory for every IFIs. It was been regulated by Bank Negara Malaysia on 1st April 2005. However, the current practices by *shariah* committee might not reveal the best role played by *shariah* committee. This was proven from study conducted by Abdul Rahman *et.al.* (2004) on the responsibility and independence of *shariah* advisors of Islamic Banks in Malaysia which indicated on the need of proper regulation on the role and function of *shariah* advisors in order to enhance the credibility of the Islamic banking activities. As such, recent development in the Malaysian context pertaining to *shariah* auditing and *shariah* review have been outlined in the newly issued guidelines "*Shariah* Governance Framework for Islamic Financial Institutions" (SGF) by Central Bank of Malaysia (BNM) on 20 May 2010 which has superseded the *Shariah* Governance Framework for Islamic Financial Institutions (2005) by stipulated that *shariah* auditing should be conducted by the Internal auditors from the internal audit department 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. All the IFI in Malaysia should comply with this new guideline by January 2011.

Hence, given the complex issues of *shariah* audit, examination and understanding of *shariah* audit and judgment affecting auditor's judgment while performing *shariah* audit is perceived to be vital. Besar *et.al.* (2009) emphasized on the importance of *shariah* audit as they highlighted that there is a need for *shariah* committee to have specified scope and well documented auditing methods during *shariah* review which clearly define *shariah* consideration to be taken in the execution of *shariah* review which is by having proper working papers, guidelines, plans and checklist to cover the scope of work provided for the *shariah* review. Abdul Rahman (2008) highlighted the need of the establishment one comprehensive *shariah* audit program which consists of a manual based document that clearly spells out step – by – step *shariah* audit procedures, policies and processes when offering Islamic financial services. The audit program should also include standard operating procedures including accounting (MASB, AAOIFI etc), regulatory requirements (BNM) and other requirements. It was supported by Haneef (1997) highlighted there an urgent needs for the Islamic economics Islamic banking and finance and as well as accounting and auditing have its own frameworks and using its own criteria due to the different of epistemology framework between Islamic thoughts and conventional thoughts.

Apart from that, though several scholars have initiated to discuss on auditing in the Islamic perspective, yet there has been no extensive continuation of these initiatives i.e. by looking from Islamic economics, Islamic finance and Islamic *fiqh muamalat* perspectives. In fact, there are limited studies conducted on the comparisons of concept between *shariah* audit and conventional audit. This is important to determine on which of conventional auditing concept that can be adopted by *shariah* audit and how far the different of the concepts can affect the way of internal auditors performing their judgment. Again, it is interesting to note that so far no specific standard on *shariah* audit has been promulgated as compared to conventional auditing from neither external auditing nor internal auditing point of view. Currently, AAOIFI and SGF Guidelines on *shariah* audit can be considered as the most relevant guideline available for *shariah* audit practice. However, whether the standard is able to cater to the practice of *shariah* audit in comprehensive manner is still another question to ponder. For that reason, as far as the most importance objective in auditing is to ensure reasonable assurance is achieved, clear concept and understanding of *shariah* audit is very crucial. The internal *shariah* auditor should satisfy himself and elicit accurate judgment that the transactions and controls he examined during his audit process comply with Islamic *shariah* rules and principles which at the end of the process he can give assurance that the IFI's internal control is properly adequate and effective.

2. Research Objective and Significance of Research

There is no doubt that Islamic finance industry will continue to be an important component of the global financial industry. Having that scenario, 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. Then, having an overview on what constitute in the practice of *shariah* audit will indicate necessary improvements to be done on these significant areas thus it will enhance the confidence of the IFIs stakeholders.

Thus, the issue of *shariah* compliance is clearly a major challenge to IFIs and the regulators. Abdul Rahman (2008), Alwi (2007) and Abdallah (1994), listed two types of *shariah* compliance which are (i) ex – ante compliance and (ii) ex-post compliance. The ex-ante *shariah* compliance is normally has been practiced by IFIs as they have *Shariah* Supervisory Board to supervise, monitor and control the task that take 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, during the conclusion and execution of the contract. However, Abdul Rahman (2008) stated that very few institutions undertake ex-post *shariah* compliance process because of it requires thorough and comprehensive *shariah* audit to review and check the transactions that took place after the execution of the contracts. Therefore, the primary objective of the 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 and the internal auditors' roles.

The study hopes to assist standards setters and regulatory bodies in setting up the relevant standards and audit program with regards to *shariah* audit. This can be done by having clear understanding on the concept, principles, objectives and approach on *shariah* audit. At the same time, the study intends to assist standards setters and regulatory bodies in determining appropriate enhancement program and certification requirements to be possessed by the internal auditors before they can conduct *shariah* audit. The internal auditor of IFIs should be proficient in applying auditing standards and procedures as well as proficient in Islamic Legal Maxims and *Usul Fiqh* relating to Islamic banking products and operations.

3. Literature Review

3.1 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. Ashton and Ashton (1995) also agreed that the auditing process is an independent review and give attestation on the function performed by independent party. In fact, Romamoorti (1993) asserted that the demand from external and internal auditing is crucial since both processes involve independent verification to reduce record – keeping errors, asset misappropriation and fraud within business operations.

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. (Gambling & Karim, 1986; Karim, 1995; Mirza & Baydoun, 1999; Hameed, 2000; Tag El Din, 2004 and Abdul Rahman, 2006) and many also viewed that current or conventional accounting cannot be used by the Islamic banks and financial institutions (Adnan, 1996; Alam, 1991 and Akhyar & Gaffikin, undated).

However, very limited studies have been devoted to the subject of 'Islamic auditing' or *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). As mentioned by Cooper (undated) quoted by Khan (1985), at present the main objective of financial auditing is to report on the 'truth and fairness of the financial position shown by the balance sheet, of the profit or loss shown by the profit and loss account and of any other information required to be disclosed in the financial accounts.

With limited study and discussions on *shariah* auditing, study done Abdelgadir *et.al.* (1994) can be assumed as one of the earliest studies done on this particular area when they studied on external audit and corporate governance in Islamic banks by looking into two different perspectives which is from practitioners and academic point of views. One of the chapters of their study concentrated on available literature on Islamic accounting and auditing and later on divided the literature into specific discussion as follows:

- The independence of external auditors in Islamic banks
- The expanded role of the external auditor in Islamic banks
- The setting of financial accounting standards for Islamic banks.

From the previous literature, Abdelgadir *et.al.* (1994) concluded that the process and development of accounting and auditing concepts and standards are totally different from the concept developed by West. Abdelgadir *et.al.* (1994) suggested that there is an urgent need for the standard setters to developed Islamic auditing framework. In addition, in Islam, auditing is indeed not a new discussion in the Islamic scientific tradition. During the early Islamic era, accounting and auditing thought can be seen as the Muslims scholars responses to the economic challenges of their times which also been influence by the guidance of *Al-Quran* and *Sunnah*. As example:

"We shall set up justice scales for the Day of judgment, not a soul will be dealt unjustly in the least. And if there be (no more than) the weight of mustard seed, we will bring it (to account) and enough are We to take account" (Al-Quran Chapter 21, verse 47) and "O you who believe! When you deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing and let a scribe write down faithfully as between the parties" (Al-Quran Chapter 2, verse 282).

Whilst, during the era of Prophet Muhammad SAW, wife of *Rasullah*, Siti Khadija listened to the accounts of her business from the prophet Muhammad or in other words, she audited *Rasullah* SAW. (Khan,1985). The development of auditing in the time of Prophet was further marked by the establishment of the institution called '*Hisba*'. According to *Al-Quran* verse 4:6 and 17:14, the term *Hisba* means "to account", "to compute" and "to measure". *Hisba* is responsible for appointing people to carry out the responsibility of enjoining good, whenever people are neglectful and forbidding evil. The main purpose of the *Hisba* institution is to safeguard the members of society from deviance, protect their faith and ensure the welfare and the people in both religious and worldly matters according to the law of God. The prophet then appointed a group of supervisors known as *muhtasib*. The role of *muhtasib* is to inspect whether the operation of the market or bazaars complied with the *shariah* principles (Mirakhor, 2000) i.e. the *muhtasib* has to inspect the weights and measures to prevent cheating and has the right to check the notaries who write down the contracts on behalf of the contracting parties and the deed of the sale (Abdullah, 2010). Principally, by looking to the functions of *Hisba*, it can be assumed that the main responsibility of *muhtasib* is parallel to the functions of *shariah* audit at broader level. *Hisba* was instituted to help regulating the society and economy to ensure full practices of the Islamic principles. As Khan (1982) summarized the role of *muhtasib* are:

- (a) To see that the community as a whole had proper organization and facilities for performance of *ibadat*;
- (b) To be responsible in the implementation of *adl* (justice) in the society;

- (c) To pay special heed to various municipal services especially the hygienic condition in the town.

In addition, the relevance of *Hisba* also been studied by Gambling & Karim (1993) as they mentioned that the roles of *Hisba* is supervising ethics in business and accounting and Abdul Rahman (1998) sees the significance of *Hisba* in corporate accountability and governance. Basically, the role of *muhtasib* is considered broad since the aim for *Hisba* institution was to preserve the benefits of the society at large and follows the law of God. However, if we further analyze, the role of *Hisba* is similar to the role of *shariah* auditing which the main aim is to preserve the activities of Islamic banking give benefits to the society and also upholding the *shariah* principles.

3.2 Shariah auditing Issues

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 (Asyraf, 2007) 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 Pallegriani, 2006). Abdul Rahman (2008) 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 (2008), 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; 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; a *shariah* review function that continuously assesses and monitoring *shariah* compliance of all activities and operations; and 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 Nawal (2009) indicated that the practice of *shariah* auditing has not seriously taken an impact in 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.

Internationally, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) played important role in developing *shariah* audit. AAOIFI through its Auditing Standard for Islamic financial institutions (ASIFI) established standards and guidance with the objective of enabling auditors to express an opinion as to whether the financial statements are prepared in accordance with *shariah* rules and principles, the AAOIFI standards and other relevant national accounting standards. The ASIFI has basically 5 chapters. The ASIFI No 1 is on the 'Objective and Principles of Auditing' , the ASIFI No 2 is on ' The Auditor's Report', the ASIFI No 3 is on ' Terms of Audit Engagement', the ASIFI No 4 is on ' *Shariah* Supervisory Board : Appointment, Composition and Report' and Lastly the SIFI No 5 is on ' *Shariah* Review'. AAOIFI also has established Governance Standard for Islamic Financial Institutions (GSIFI) which discussed closely on the issues of *shariah* auditing through GSIFI No 2 '*Shariah* Review'.

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 (Khan, 1985; Al-Abiji, 1989; Nejatullah, 2006 and Rifaat (undated)). 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 Rifaat (undated) 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. Rifaat (undated) 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.

4. Research Methodology

This study employs a series of interviews with individuals involved in *shariah* audit from varieties of background. The overall aim of the interviews was to shed further light on the current practices of *shariah* auditing and to elicit the level of understanding 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:

- (i) Scope and extent of *shariah* auditing
- (ii) The current framework adopted by the IFIs
- (iii) Relationship with *shariah* review and *shariah* committee
- (iv) Governance and reporting line of internal auditor
- (v) Competency requirement
- (vi) Challenges and limitation

Five in depth interviews were conducted which are; two chief internal auditors, two managers of internal audit department and one of *shariah* committee. The diversification of participant's background is to ensure that the study can gauge 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 a semi – structured questionnaires was utilized to guide the interview as delineated at the appendix. All participants appeared confident and seemed to have a very good understanding of the organizations background, structures and process of *shariah* auditing.

The interviews then were transcribed and coded using the key themes related to the main research objectives and subsequently re-checked for errors in the classification of themes were reviewed and consensus reached before pre-coding. This practiced was been adopted from Zain (2005) and Patton (2002). After that, the interviews responses were presented in the form of a matrix framework. This is important to compare the responses across the five interviews been conducted. The matrix format draws attention to presence or absence of consistency and consensus across different respondents and as such is a useful tool for identifying commonalities and differences in the research themes. (Miles & Huberman, 1984 and Martin & Meyerson, 1988) – As quoted in Md Zain (2005). The matric framework as provided in appendix 1 which compares and contrast the current practices of *shariah* auditing in terms of two themes as abovesaid.

5. Findings and Discussions

The findings from semi - structured interviews (please refer to appendix 1) are discussed under 2 main themes as follows:

- (1) Definition of *Shariah* auditing – contrasting the definition from Islamic perspectives and Conventional perspectives
- (2) Current practices of *Shariah* auditing in terms of :
 - (i) Scope and extent of *shariah* auditing
 - (ii) The current framework adopted by the IFIs
 - (iii) Relationship with *shariah* review and *shariah* committee
 - (iv) Competency requirement
 - (v) Governance and reporting line of internal auditor
 - (vi) Challenges and limitation

5.1 Definition of Shariah auditing – contrasting the definition from Islamic perspectives and Conventional perspectives

All the five participants agreed and understood the definition of *shariah* auditing as stated in the *Shariah* Governance Framework for Islamic Financial Institutions (SGF) (2010) issued by Central Bank Malaysia 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 preserved and comply with *shariah* principles. All the participants also agreed that, *shariah* auditing function is important for the bank to reduce the compliance risks of the banks and a part from that, the internal audit department also performed consulting practices to other department such as to advice and consultation in setting up sound and effective internal control to preserved *shariah* principles. In terms of contrasting the definition from Islamic perspectives and conventional perspectives, all the participants indicated that, the definition and practices of *shariah* auditing and conventional auditing is similar except the main objective of the *shariah* auditing is to ensure sound and effective of internal control for *shariah* compliance. This can be

contrasted clearly from definition of *shariah* auditing issued by Central Bank Malaysia (BNM) stipulated in SGF (2010) and the definition of internal auditing by Institute of Internal auditing as follows:

"Shariah audit refers to 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 compliance" – Stipulated in SGF (2010)

While the internal auditing definition is:

"Internal auditing is more concerned to give independent, objective assurance and consulting activity which designed to add value and improve an organization's operation. It helps an organization accomplish its objectives by bringing a systematic discipline approach to evaluate and improve the effectiveness of risk management, control and governance". (International Professional Practices Framework (IPPF), IIA)

However, all the participants agreed and admitted that the process of *shariah* auditing is more effective and sound if the internal auditor has relevant and adequate knowledge on Islamic *Fiqh Muamalat* and Islamic legal contracts/maxims. The knowledge of these two areas will enhance the process of auditing as the internal auditor will more appreciate and alert on the issues of *shariah* non-compliance. This Islamic knowledge also can make the approach and process of conducting *shariah* auditing is different from conventional auditing process.

5.2 Current practices of Shariah auditing in terms of:

5.2.1 Scope and extent of shariah auditing

In SGF (2010), it was stipulated that, the *shariah* auditing function should be performed by internal audit department of the bank. Currently, the Islamic finance in Malaysia showing significant number of full-fledged Islamic banks including several foreign owned entities and also some conventional banking institutions that have established Islamic banking subsidiaries or known as Islamic banking windows. The result from the interviews shown that, the *shariah* auditing is been performed by the group internal audit department and none of the organizations have a dedicated unit in the internal audit department been established to specifically perform *shariah* auditing. Therefore the participants agreed and confirmed that all the internal auditors within a department are responsible to perform *shariah* auditing when he or she needs to conduct internal audit on certain Islamic banking operations or products. The participants also agreed that the internal audit department should design their *shariah* auditing program to cover all aspects of the IFIs business operation and activities such as audit of financial statement, compliance audit and review on internal controls of organizational structures, people, process, information technology and lastly review on *shariah* governance. The participants' understanding regarding the scope and extent of *shariah* auditing is in line with the SGF (2010) which has highlighted same issues.

However, according to 4 participants, in reality, practices of *shariah* auditing are still at minimum and need a lot of improvement. In fact, according to some of them, the *shariah* auditing is only been performed at the surface level of auditing process such as fulfilling an audit program checklist and some of the internal auditor still leveraging the conventional audit program and understanding while they are performing audit on certain Islamic products and operations. This approach is certainly erroneous due to the different natures and concepts of the Islamic banking products and operations in ensuring compliance on certain *shariah* principles. For instance, the *ijarah* contracts should fulfill *ijarah* contract's conditions i.e. proper evidence of ownership must be in place to support the fact that the asset is in the ownership of the IFIs including accounting treatment and claim for capital allowances to local accounting and tax regulations. Therefore some of the participants claimed that, only a few internal auditors have a good understanding on certain concepts of Islamic banking and its nature of operation which have caused wrong interpretation of results and finally lead to *shariah* non-compliance issues. In addition, the participants also commented that the *shariah* auditing practices was not effectively implemented due to insufficient time to conduct the *shariah* auditing and lack of expertise. Therefore, out of five interviews, participant's response on whether their IFIs effectively implement the *shariah* audit reported as follows; 2 respondent reported effective, another 2 respondents said quite effective and 1 *shariah* committee claimed that the *shariah* auditing in the banks is not effective.

5.2.2 The current framework adopted by the IFIs

Under this sub-section, the research investigate on how the approach or process have been adopted by the internal audit department in relation to the framework or standards, audit process, audit program and plan they are adopted. The result indicated that, the internal audit department adopted a framework or standards as stipulated in the International Standards for Professional Practice of Internal Auditing (IPPF) issued by the Institute of Internal Audit (IIA) and Guidelines on Minimum Audit Standards for Internal Auditor of Financial Institution Issued by Malaysia Central Bank (BNM). At the moments, there is no standards specifically design for *shariah* auditing. The *shariah* auditing is being performed in all unit of business operation which normally depends on the group internal audit risk assessment and annual internal audit plan conducted by the internal audit department. Out of 4 interviews revealed that current practices of *shariah* audit program in IFIs are shared with the conventional audit program, which in some extent this audit program will involve certain modifications to be adopted when it applies to Islamic banking products and operations. Only one participant stated that their organization has designed a structured *shariah* audit program which specifically for *shariah* auditing purposes. However, the participant claimed that the *shariah* audit program still needs improvement due to lack of step-by-step shari'ah audit procedures, policies and processes when offering Islamic financial services. The audit program should also include standard operating procedures including accounting (MASB, IFSB etc.), regulatory requirements (BNM) and other requirements. In addition, the participants were asked whether it is essential for the IFIs to have its own *shariah* audit framework and program. Then, all the participants noted that, the Malaysia Central Bank (BNM) should at least issues a general framework and general list of audit program to be used as a guideline for the IFIs. The objective of the framework is to help the IFIs to design their own *shariah* auditing framework and program which will be based on their natures and types of Islamic banking products and operations they have offered.

5.2.3 Roles of shariah review function and shariah committee in shariah auditing

According to SGF (2010) the internal auditors may engage the expertise of the IFIs *Shariah* officers from *Shariah* reviews functions and *shariah* committee in performing the audit, as long as the objectivity and independence of the audit is not compromised. The interviews indicated that the internal auditors having close working relationship with the *shariah* review department particularly related to confirming *shariah* principles and practices such as the internal audit department reviews the *shariah* compliance framework and internal control. In the meantime, the *shariah* reviews department act as a referral point for the internal audit department to get confirmation and clarification on certain of *shariah* issues. In addition, all the participants from the interviews seems well understood the roles and function of *shariah* review department which to ensure *shariah* compliance in all Islamic banking activities. However, in terms of relationship between the internal auditor and *shariah* committee, several of different practices were found from the interviews. About 2 participants agreed that their internal audit department had close working relationship with the *shariah* committee. While, 1 of the participants stated that they had quite close working relationship and lastly 2 participants claimed that the IFIs' *shariah* committee did not perform an active oversight role on *shariah* audit function. This practice violated the SGF (2010) as the guideline stipulated that the *Shariah* Committee is expected to perform an oversight role on *Shariah* matters related to the institution's business operations and activities which can be done through *shariah* review function and *shariah* audit function. The *shariah* committee's active roles also can be measured through their participation in audit committee meeting. However this practices still varies among the IFIs. 2 participants informed that their *shariah* committee is invited to attend board of directors meeting as well as the audit committee meeting. While, another 2 participants stated that their *shariah* committee is only invited to attend audit committee meeting, and lastly, 1 participant (which the participant is a *shariah* committee) claimed that they could not play an active roles since the management do not really accept and understand the importance of *shariah* committee's roles in developing the *shariah* audit program and assisting internal auditor in reviewing *shariah* auditing process. As a consequence, the *shariah* committee was not invited to attend any audit committee meeting and board of directors meeting. One interesting finding from this interview also revealed that, in some situations, their roles are denied by the management by putting a limit and discard *shariah* committee to participate actively in the internal audit department. Lastly under this sub – section, the interviews investigate the formal reporting channel practiced by the internal audit department regarding findings from *shariah* auditing process.

5.2.4 Governance and reporting line of internal auditor

The result from the interviews stated that all the IFIs complies with the SGF (2010) guidelines as their governance and reporting line of *shariah* internal auditor are required to report to board of audit committee of the IFIs and *shariah* committee. Then, for any *shariah* non - compliance issues the internal audit department is also required to report to the board of directors of the IFIs.

5.2.5 Competency requirement

All the participants strongly agreed that *shariah* knowledge is important to be possessed by the internal auditor especially when they are involved in *shariah* auditing process. According to 1 participant, he/she mentioned that the internal auditor should possess this knowledge to appreciate and understand the condition of each of the *shariah* principles which the internal auditor then immediately can identify any violations of *shariah* principles in Islamic transactions and operations. A closer analysis of the SGF (2010) related to internal auditor's competency requirement, revealed that a general guideline was postulated. The SGF (2010) principles 7, para 7.8 stated that; "*the function shall be performed by internal auditors, who have acquired adequate Shariah-related knowledge and training*". The result from the interviews indicated that the IFIs did not perceive the importance of *shariah* knowledge to be possessed by their staffs. Only 1 participant stated that their staffs are made compulsory to attend and participate in Islamic *Fiqh Muamalat* and Islamic Legal Maxims training or workshop. The internal auditor's participations will be evaluated in the staff key performance indicators (KPI). Meanwhile, another 4 participants stated that, their organizations only strongly encourage the staff to attend and enroll in any Islamic banking and finance courses but not mandating it as a compulsory action that need to be fulfilled. 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. Therefore, this study also tries to explore the perception whether the *shariah* auditing should only be performed by Muslims or not. As a result, all the participants do not agree with the perception but outlined certain condition should be fulfilled by non – Muslim such as the non – Muslim internal auditor should adequately has *shariah* knowledge and able to apply the knowledge in every transactions in Islamic banking products and operations. However, according to all participants of the interview, *shariah* officers should only comprise of Muslims followers due to the extensiveness of *shariah* review that need to be performed by them.

5.2.6 Challenges and limitations

All the participants from the interviews clearly indicated that their major challenges of implementing effective *shariah* auditing are due to lack of expertise and resources. This implies that not many internal auditors have sufficiently and adequately Islamic *shariah* knowledge and understand Islamic financial system as well as at the same time, not many *shariah* officer well understand the conventional financial system which can make them to be more critical to compare and contrast the different between these two financial systems. The plausible explanation from this problem may be due to lack of courses offered at the university level from a combination of Accounting and Auditing courses and Islamic principles courses. Furthermore, another challenge in implementing effective *shariah* auditing is lack of support from management. The finding proves that only 2 participants agreed that the management plays an important role in supporting *shariah* auditing practices. While, the other 3 of participants stated that the management does not perceive the importance of *shariah* auditing. The sentiment against this is due to the perception that *shariah* auditing is similar to conventional or normal practices of auditing.

6. Conclusion

This research intends to contribute towards a better understanding of the current practices of *shariah* auditing in a unique environment of Islamic banking which requires different philosophical concept. Hence, this study aims to increase the understanding *shariah* audit, viewing *shariah* audit in the context of Islamic banks from a broader perspective (to achieve and fulfill Muslims societies interest) which also encompasses a bigger audit scope and hence serious concern should be undertaken to establish the subject systematically and put it in practice according. The result from the interviews found that the IFIs still struggling to establish effective *shariah* auditing framework and program. This finding is supported by other study that found the IFIs have to depend on the conventional auditing framework for audit purposes which is limited in scope, despite the obligation to meet the objectives of the *shariah* (Nawal et. al, 2009). The study also indicate that, the *shariah* auditing practices still needs a lot of improvements such as in terms of improving understanding among the internal auditor, implementation of *shariah* auditing process, fulfilling resources and expertise requirement and support from management. One of the limitations in this research is due to its qualitative nature hence not able to generalize to explain the population. The next stage of our research is to conduct survey and experiment.

Acknowledgement

This paper is under research grant received from International Association for Accounting Education and Research

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Appendix 1

The Structured Interviews Data Matrix

Participants	P1	P2	P3	P4	P5
<u>Demographic Details</u>					
Gender	Female	Male	Female	Male	Male
No of years with Firm	More than 5 yrs	1 yrs	3 yrs	3 yrs	2 yrs
No of Years as and internal auditor	More than 20 yrs	15 yrs	10 yrs	7 yrs	2 yrs as <i>shariah</i> committee
<u>Background of Companies</u>					
Full Fledged Islamic Banks		✓			
Windows of Islamic Banks	✓		✓	✓	✓
(i) Research Questions - What should be the definition of <i>shariah</i> audit					
- To validate and give assurance that the internal control of the company is effective and efficient to preserved and comply with <i>shariah</i> principles	Yes	Yes	Yes	Yes	Yes

- To reduce risk for bank	Yes	Yes	Yes	Yes	Yes
- Give consulting i.e. to advise and consultation in setting up internal control	Yes	Yes	Yes	Yes	Yes
- Similar to conventional/normal audit i.e. in terms of Audit Methodology used (audit program and checklist)	Similar to conventional -but the internal auditor is strongly encourage to have good understanding relating <i>shariah</i> knowledge	Similar to conventional - but the internal auditor is strongly encourage to have good understanding relating <i>shariah</i> knowledge	Similar conventional - but for P3, the difference of <i>shariah</i> audit is due to the the main objective of <i>shariah</i> audit which is to consider the importance of complying <i>shariah</i> principles. Therefore, the audit methodology or program design must specifically design for <i>Shariah</i> audit P3 also agreed that it is important for the internal auditor to have good understanding relating <i>shariah</i> knowledge	Similar to conventional - but the internal auditor is strongly encourage to have good understanding relating <i>shariah</i> knowledge	Similar but must be in depth and focused to fulfill <i>shariah</i> compliance - but the internal auditor is strongly encourage to have good understanding relating <i>shariah</i> knowledge
(ii) Research Question - What is the current practices of <i>shariah</i> audit ?					

<u>(1) Scope and extent of Shariah auditing</u>					
(1a) Practices of <i>shariah</i> auditing	Perform by Group Internal audit Yes	Perform by Group Internal audit Yes	Perform by Group Internal audit Yes	Perform by Group Internal audit Yes	Perform by Group Internal audit Yes
(1b) Perform in all activities that encompasses Islamic banking operation and structures (covers in all Islamic banking systems)	Only at their windows	All operations because of full fledge of Islamic bank	Only at their windows	Only at their windows	Only at their windows
(1c) Existence of one dedicated unit to perform <i>Shariah</i> audit	No – every internal auditors need to perform <i>shariah</i> audit - but they have person in charge to be act as referral point for any <i>shariah</i> audit issue	No - every internal auditors need to perform <i>shariah</i> audit - but they have person in charge to be act as referral point for any <i>shariah</i> audit issue	No - every internal auditors need to perform <i>shariah</i> audit - but they have person in charge to be act as referral point for any <i>shariah</i> audit issue	No - every internal auditors need to perform <i>shariah</i> audit - but they have person in charge to be act as referral point for any <i>shariah</i> audit issue	No - every internal auditors need to perform <i>shariah</i> audit - but <i>Shariah</i> Committee is appointed to help the Internal audit in developing <i>shariah</i> audit program
(1d) Level of current practices of <i>shariah</i> auditing in IFIs	Already in placed but need to cater and add some audit programe that can check <i>shariah</i> compliance issues – The interviewee in opinion that	Already in place and didn't facing difficulties since their bank is full fledge and solely following <i>shariah</i> principles. However he's commented on	Already in place but they are only leveraging the conventional audit methodology and program. The interviewee in opinion that, the banks should strengthen and	Already in place but they are only leveraging the conventional audit methodology and program. The interviewee in opinion that, the banks should strengthen and	Already in place. But need many improvements in conducting <i>shariah</i> audit. Even though many CIAs said that they are practicing <i>shariah</i> audit, but the issues is to what

	<p><i>shariah</i> auditing framework and practices cab be leveraged from the existing framework</p> <p>- Effective</p>	<p>the relevancy of <i>shariah</i> auditing framework to be used in Full Fledge Islamic bank, since the framework is more incline to Islamic windows bank</p> <p>- Effective</p>	<p>improve the way they conduct <i>shariah</i> auditing since it just cover certain area at the surface level.</p> <p>- still insufficient due to time constraint and resources</p> <p>- Quite effective</p>	<p>improve the way they conduct <i>shariah</i> auditing since it just cover certain area at the surface level.</p> <p>- still insufficient due to time constraint and resources</p> <p>- Quite effective</p>	<p>extent the <i>shariah</i> auditing is being performed?.</p> <p>Not effective</p>
<u>(2) Current framework use</u>	<p>Shared with Conventional but with certain modification when its relates to Islamic banking system</p> <p>- Shared</p>	<p>Structured and specifically designed audit program for Islamic banking system</p> <p>- Not shared</p>	<p>Structured and specifically designed audit program for Islamic banking system – but very loose</p> <p>Not Shared</p>	<p>Shared with Conventional but with certain modification when its relates to Islamic banking system</p> <p>Shared</p>	<p>Shared with Conventional but with certain modification when its relates to Islamic banking system</p> <p>Shared</p>
(2a) Based on general audit Plan	Yes – annually	Yes - annually	Yes - annually	Yes - annually	Yes - annually
(2b) Based on Group Internal	Yes	Yes	Yes	Yes	Yes

Audit Risk Assessment					
(2c) Industry in need to have new framework?	No But agreed to have one general framework that can be used to standardized the practices of <i>Shariah</i> auditing among IFIs - should be considered to have one framework	No But agreed to have one general framework that can be used to standardized the practices of <i>Shariah</i> auditing among IFIs - should be considered to have one framework	No But agreed to have one general framework that can be used to standardized the practices of <i>Shariah</i> auditing among IFIs - should be considered to have one framework	No But agreed to have one general framework that can be used to standardized the practices of <i>Shariah</i> auditing among IFIs - should be considered to have one framework	Yes
<u>(3) Relationship with <i>Shariah</i> review department and <i>Shariah</i> Committee</u>					
(3a) Relationship with <i>Shariah</i> review i.e. assisting <i>shariah</i> review department to establish <i>shariah</i> compliance framework and control	Close working relationship	Close working relationship	Close working relationship	Close working relationship	Close working relationship
(3b) Relationship with <i>Shariah</i> Committee	Close working relationship and the SC is their referral point and in fact, the <i>shariah</i>	Close working relationship and the SC is their referral point	Close working relationship	Close working relationship and the SC is their referral point	Close working relationship and the SC is their referral point and in fact, the <i>shariah</i> committee assist the internal

	committee assist the internal audit in developing <i>shariah</i> audit program - Very close	- Quite close	- Not very close	- Not very close	audit in developing <i>shariah</i> audit program - Very close
(3c) Understanding of roles of <i>Shariah</i> Review – as stated in SGF	Yes they agreed and understand the <i>shariah</i> review department Very good understanding	Yes they agreed and understand the <i>shariah</i> review department Very good understanding	Yes they agreed and understand the <i>shariah</i> review department Very good understanding	Yes they agreed and understand the <i>shariah</i> review department Very good understanding	Yes they agreed and understand the <i>shariah</i> review department. But according to interviewee, the roles of <i>shariah</i> committee is wide and should plays more important roles in more aspect – can not only rely on SGF Very good understanding
(3d) Roles of <i>shariah</i> committee in BOD and Audit committee	SC sitting in the BOD and invited internal auditor to attend <i>shariah</i> committee	SC was invited to attend in the BOD but not in AC	SC sitting in the AC	SC sitting in the AC	Only advise in terms of <i>shariah</i> matters – Not sitting in BOD and AC

	meeting. But She in opinion that, the <i>shariah</i> committee can be in BOD as long as they are business savvy				
	Active	Quite active "by invitation"	Quite active	Quite active	Not active
(3d) Reporting and governance structures of <i>Shariah</i> review department	To <i>Shariah</i> Committee and BOD of Bank	To <i>Shariah</i> Committee and BOD of Bank	To <i>Shariah</i> Committee and BOD of Bank (CIMB Islamic)	To <i>Shariah</i> Committee and BOD of Bank (Saadiq)	To <i>Shariah</i> Committee and BOD of Bank (HSBC Amanah)
<u>(4) Competency requirement</u>					
(4a) Compulsory for the internal staff to possess <i>shariah</i> certification	Yes – Measured in their KPI	No – only strongly encourage	No - only strongly encourage	No – but the internal auditors are required to obtain Certificate in Islamic Law (CIL)	No - only strongly encourage
(4b) The perception regarding the importance of understanding in <i>Shariah</i> Principles – through possessing adequate <i>shariah</i> knowledge	Yes – Very important	Yes – Very important	Yes – Very important	Yes – Very important	Yes – Very important
(4c) The perception regarding whether only Muslim internal	Not agreed – but non muslim	Not agreed – but non muslim	Not agreed – but non muslim internal	Not agreed – but non muslim internal	Not agreed – but non muslim internal

auditor can perform <i>shariah</i> audit	internal auditor must have adequate <i>shariah</i> knowledge	internal auditor must have adequate <i>shariah</i> knowledge	auditor must have adequate <i>shariah</i> knowledge	auditor must have adequate <i>shariah</i> knowledge	auditor must have adequate <i>shariah</i> knowledge
(4d) The perception regarding whether only Muslim can be <i>shariah</i> review officer – and possed Islamic certificate i.e. fiqh muamalat	Yes and agree – due to extensive <i>shariah</i> review which required to be perform i.e. daily basis	Yes and agree	Yes and agree	Yes and agree	Yes and agree
<u>(5) Governance and reporting line of <i>shariah</i> internal auditor</u>	To BOD and AC	To BOD and AC	To BOD and AC	To BOD and AC	To BOD and AC
<u>(6) Challenges and Limitations</u>					
(6a) Constraint in terms of resources and expertise	Yes and agree	Yes and agree	Yes and agree	Yes and agree	Yes and agree
(6b) Not competent in terms of possessing <i>shariah</i> and usul fiqh knowledge	Yes and agree	Yes and agree	Yes and agree	Yes and agree	Yes and agree
(6c) Lack of awareness and understanding of conventional and Islamic financial system among internal auditor and <i>shariah</i> officer	Yes and agree	Yes and agree	Yes and agree	Yes and agree	Yes and agree
(6d) Perception and level of acceptance that the <i>shariah</i>	High and	High and	Not seen the <i>shariah</i> audit as a major audit	Not seen the <i>shariah</i> audit as a major audit	Not seen the <i>shariah</i> audit as a major audit

auditing is importance to be conducted among the Management	encouraging - Very effective	encouraging - Very effective	process which need to be conducted. This is due to the perception that <i>shariah</i> audit is similar to normal/conventional audit Not effective	process which need to be conducted. This is due to the perception that <i>shariah</i> audit is similar to normal/conventional audit Not effective	process which need to be conducted due to the perception that <i>shariah</i> audit is similar to normal/conventional audit Not effective