

Risk Based Internal Shariah Audit Practices in the Islamic Bank

Nurulhuda Abd Rahman*

Faculty of Accountancy, Universiti Teknologi MARA, Malaysia

Nor'azam Mastuki

Arshad Ayub Graduate Business School, Universiti Teknologi MARA, Malaysia

Nawal Kasim

Faculty of Accountancy, Universiti Teknologi MARA, Malaysia

Muhamad Rahimi Osman

Academy of Contemporary Islamic Studies Universiti Teknologi MARA, Malaysia

Abstract

Shariah audit is an essential key function to ensure Shariah compliance in Islamic banking institutions. Shariah audit complements existing functions of conventional internal audit, which is lacking in providing adequate assurance on Shariah compliance. Hence, there is a need to incorporate Shariah audit function to existing corporate governance framework of Islamic banks (IB). However, there is not much guidance that auditors could refer to in order to perform comprehensive Shariah audit procedure. The current study intends to provide in-depth explanation on the process of internal Shariah audit, particularly on the planning, execution and reporting, also follow up phases. It focuses on the application of risk-based internal audit (RBIA) approach in the practices. The study adopts a qualitative approach of single case study in an attempt to achieve its objectives. By providing detailed explanation on practices of internal Shariah audit in Islamic banks, findings are expected to contribute in supplying valuable in-depth information for Islamic banks, as well as other Islamic institutions. This information is especially important for in strategizing internal Shariah audit practices as an important control and monitoring strategy in their business operation.

Keyword: Shariah audit; Shariah compliance; Islamic banking.



CC BY: [Creative Commons Attribution License 4.0](https://creativecommons.org/licenses/by/4.0/)

1. Introduction

Islamic banking industry (IBI) is developing drastically in the 21st century due to factors such as liberalization policy to foreign banks and introduction of Islamic banking subsidiaries. The development of this industry has also seen changes on regulatory requirements and product innovations that might involve complicated accounting treatments (Islamic Banker Asia, 2014). This recent situation hence requires Shariah compliance functions in IBI to be upgraded to become more relevant for the industry. There are many studies conducted on Shariah compliance function. For example, Kasim *et al.* (2009) had studied on the gap between expected and actual Shariah audit practices of Islamic finance institutions, while Yaacob and Donglah (2012) had explained about postgraduate students' perceptions on Shariah audit. Further, DeLorenzo (2010) and Mohiuddin (2012) had explained on how auditing should be performed by referring to Islamic principles. Yaacob and Donglah (2012) and Yahya and Mahzan (2012) had discussed on issues and challenges of Shariah audit in Islamic financial institutions which include requirements of knowledge and specified Shariah audit framework. Another study by Shafii *et al.* (2013) had discussed on Shariah auditor's knowledge and competency. Yahya (2018), preliminary study on Shariah auditing practices found that external auditor questioned whether internal Shariah audit should use risk-based audit in the practices. The assessment of risk is important in ensuring risk is being managed by the institution. It is found that limited in-depth analyses of Shariah audit practices. The analysis includes how is the practice of the internal Shariah audit in the Islamic banking institution without availability of specific guidance on the practices. In view of this gap, this study intends to provide in-depth explanation on practices of internal Shariah audit as one important control and monitoring strategy for the business. The explanation includes the process of Shariah audit planning, execution, reporting and follow up audit.

2. Literature Review

2.1. Shariah Audit in Islamic Banks

According to Shariah Governance Framework (SGF) (Bank Negara Malaysia, 2011), 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 Islamic Financial Institution's (IFI) business operations, with the main objective of

ensuring a sound and effective internal control system for Shariah compliance and be performed by internal auditors". (Bank Negara Malaysia, 2011)

SGF also stipulated that internal auditors from internal audit department should conduct Shariah audit, hence they should be competent with respect to Shariah knowledge. Internal audit department performs its role as the third line of defence in an institution. As such, attachment of Shariah audit function to internal audit department will not jeopardize the issue of independence since Shariah audit findings are directly reported to audit committee of the IB (Shafii *et al.*, 2013).

Further, in terms of Shariah audit execution, it should be conducted before, during, and after the execution of any financial transactions. This is known as ex-ante and ex-post examination (Bangash, 2012; DeLorenzo, 2010; Rahman, 2008). Rahman (2008), explained that ex-ante Shariah compliance is basically Shariah Advisory Councils' (SAC) supervision, monitoring and control tasks that take place upon and during implementation of bank's dealings. These activities include ensuring that banks and financial institutions comply with Shariah rules and guidelines during designing of contracts and agreements; during the process of transactions; during conclusion and execution of contract; up to the implementation of contract terms and liquidation.

Meanwhile, ex-post Shariah compliance process requires thorough and comprehensive Shariah audit to review and examine transactions that takes place after execution of contracts. Ex-post Shariah compliance is basically performing random samples of completed transactions to ensure that these transactions conform to requirements of Shariah. Earlier supervision and control may save costly legal fees that may be required at a later stage if elements of proposed business/contracts need to be modified to comply with Shariah principles and precepts (DeLorenzo, 2010).

However, Rahman (2008) also stated that very few institutions undertake ex-post Shariah compliance process. As this finding was revealed before the issuance of SGF, recent study should be undertaken to discover current implementation of ex-post Shariah compliance practices. Generally, IFIs tend to emphasize on ex-ante processes, which are strictly monitored by regulators. However, problems of non-compliance often starts in support functions, which are generally left to the individual IFIs to be implemented and monitored (Hussan *et al.*, 2013).

3. Shariah Audit Process and Methodology

3.1. Audit Planning

Audit plan should be properly documented to include sample selection criteria and sizes, taking into consideration complexity and frequency of transactions. There are certain aspects of audit fieldwork which require sampling techniques. More detailed examination of documentations would be necessary whether or not sampling methodology is used (Bangash, 2012; Rahman, 2008).

Preparation of audit plan has shifted from control assurance on cyclical or routine audit plans to control assurance based on risk-based internal audit plan (RBIA) (Pricewaterhousecoopers, 2007). In planning each audit engagement, adoption of risk-based approach is correlated positively with entity size. Internal auditing is more proactive in the implementation of Enterprise Risk Management (ERM) in smaller organizations, and is more important in the finance industry and private sector (Castanheira *et al.*, 2010).

Audit program will be able to identify key auditing processes which need to be undertaken, objectives of each activity and techniques that will be used (including sampling techniques) to achieve each audit objective (Onagun and Mikail, 2013). A study on effectiveness of SGF found that most of their respondents (89.6%) have specific planning or schedule for Shariah audit exercise (Hassan *et al.*, 2014).

Development of Shariah audit program is important to ensure that exact procedures for each product in IFI are being followed (Rahman, 2008; Shafii *et al.*, 2010). It consists of Shariah audit procedures, policies and processes when offering Islamic financial services; also standard operating procedures which includes accounting, regulatory requirements and other necessary requirements. The program also includes audit techniques to be used, including examination of papers, interviewing, benchmarking, surveys, case studies, flow charting and others. This plan should consider all available resources, while at the same time being effective and able to cover pre-determined scope and objectives. It must be properly documented with consideration of sample criteria and sizes, as well as contemplating complexity, frequency of transactions into this consideration. It should be adequately developed to be capable of auditing Islamic Bank's operations (Bangash, 2012).

Research by Yahya and Mahzan (2012) revealed a situation where Shariah audit program in IFIs are shared with conventional audit program, which in some extent this audit program involves certain modifications that needs to be adopted when it is applied to Islamic banking products and operations. The use of conventional audit program or any other standards is acceptable, as long as it does not contravene with Shariah principles. It is recommended be the study to apply international internal auditing standards and to be consistent with Islamic jurisprudence standards of accounting (Al-Sharairi and Alsharayri, 2012).

3.2. Audit Execution

IFIs should systematically undertake comprehensive Shariah audit to ensure proper Shariah compliance. In absence of proper guidelines to undertake Shariah audit, many IFIs have difficulty in properly planning, executing and reporting Shariah audit (Rahman, 2011). During the examination stage, Shariah auditor would identify and deploy proper audit techniques to gather sufficient and reliable evidences. This is so that reasonable conclusions can be reached on Shariah compliance. The Shariah audit execution process involves an understanding of the management's awareness, commitment and compliance control procedures to adhere with Shariah; reviewing of contracts, agreements and transactions in accordance to Shariah; also ascertaining whether transactions are made for

products authorized by Shariah. Some information and reports such as circulars, financial reports, policies and procedures, observations, as well as recommendations over transactions have been found to be against Shariah or do not adhere to Shariah rules and regulations (Bangash, 2012). To overcome this issue, Shariah compliance for operations which is based on these documentations can be attested against various sources ranging from regulations, Shariah guidelines, also accounting and auditing standards from regulators such as Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI). Rosly (2010), argued that there are four approaches that must be applied simultaneously in determining Shariah compliance status to avoid costly errors that might lead to litigations and loss of competitiveness in Islamic financing business. These approaches are *aqad*, financial reporting, legal documentation and objective of Shariah.

3.3. Reporting and Follow up Audit

In order to ensure that the internal audit report is presented independently, the report should be presented, reviewed, and endorsed by the Board Audit Committee. The competency of the individual performing the audit is of little value if he or she is biased in the accumulation and evaluation of the evidence. The audit report must be presented to the SC to resolve the issue (Hassan *et al.*, 2014; Rahman, 2011; Shafii *et al.*, 2013; Triyanta and Rusni, 2011).

The content of the report should be objective, clear, constructive and timely, and include the purpose, scope, findings, opinion, recommendations, corrective actions, feedback from the reviewers, and any dispute relating to the Shariah interpretation to be resolved by the SC (Rahman, 2011; Shafii *et al.*, 2010). If there are any disputes or differences of opinions between the management and the internal Shariah auditors on the matters relating to Shariah, the interpretation and final decision will be referred to the SC of the respected IFIs (Rahman, 2011). The Shariah aspects in the report are the distinctive features which differentiate the Islamic banking from the conventional banking as the Islamic bank has to comply with the Shariah principles in all operations and products (Triyanta and Rusni, 2011).

The Shariah audit reporting can be prepared and published alongside the financial auditor's report in the annual report. It can be used to determine whether the auditor able to gain access to all financial records and documents in exercising the auditing duties and states whether the balance sheet and the profit and loss account were in compliance with the Islamic law (Rahman, 1998). As an institution in a fully regulated industry, it should comply with all regulatory requirements. In Malaysia, the IFIs should follow the BNM GP8-i guidelines. All internal audit and internal control activities should be included in the Statement of Corporate Governance and audit report that include the opinion whether the institution complies with all the Shariah requirements (Bank Negara Malaysia, 2005) besides the reporting requirements from AAOIFI. It is found that some of IFIs chose to follow the specimen provided by AAOIFI or with slight modifications.

The Shariah auditor has to perform the follow-up audit to ensure that all the necessary actions were taken. The auditor has to follow-up the corrective action and recommendations so that the actions are rectified besides preventing the recurrence of non-compliance (Shafii *et al.*, 2010). The follow-up process follows the requirements in the SGF in which the audit process involves providing recommendations on the rectification measures and ensuring the implementations by the IFIs (Bank Negara Malaysia, 2011). The reporting requirements and follow-up activities intended to avoid the non-compliance in Shariah. This study will explain the process of reporting and follow-up by the internal Shariah audit.

4. Research Methodology

This study adopts a qualitative approach with interpretive paradigm and single case study method, bounded by the scope of IFIs (Yin, 2003); (Creswell, 2012). Analysis was done inductively during and after data collection process in order to establish patterns or themes. This is done as the researcher becomes the main research instrument in this qualitative approach (Creswell *et al.*, 2007). Inductive analysis is conducted in parallel with data collection process to enable for identification of any new emerging issues, also to continuously plan for research process of the current study. Transcriptions from interviews were prepared and analysed using non-mathematical procedure. Further, data analysis was conducted with the help of the latest computer software, ATLAS.ti.

This study begins with a preliminary study, in which its findings were used to select the main case study and develop interview questions for the main case study. This study has chosen a full-fledged Islamic banking institution as it focuses on the internal Shariah audit without interference with conventional and operational internal audit. It is a well-established bank that is considered an extreme case, and obtaining the information of an unusual case is especially good (Flyvbjerg, 2006; Yin, 2003). The internal Shariah audit was practiced before the issuance of SGF. The bank's internal Shariah audit applied acceptable internal audit methodology such as the use of RBIA and Committee of Sponsoring Organisations of the Treadway Commission (COSO) framework. These are the distinguishing characteristics of the bank.

Participants for preliminary study include Legal Advisor, Manager of Internal Shariah Audit, Head of Compliance and Control Department, Advisor, Chief Internal Auditor, Head of Shariah Audit, Member of SC and Manager of Internal Shariah Audit Department of several Islamic banks in Malaysia. In the main case study, there were two phases of interviews being conducted, whereby the first phase had focused on the understanding of Shariah audit practices while phase two had focused on refining all the data that have been collected. Purposive sampling was used in the current study, as it is effective when data review and analyses are done in conjunction with data collection. Subsequent participant selection was selected via snowball sampling. Selections of participants ended when the current study reaches a saturation point, where major themes have been identified. A saturation point is

also reached as there is no new information that can be added into the list of theme or to details for existing themes. Participants of interviews include General Manager, Member of Shariah Committee, Chief Internal Auditor, Head of Shariah, Head of Shariah Audit, Shariah Auditor, Head of Shariah Review, Risk Management Manager and Branch Manager. Findings of this study include information on Shariah audit process, which consists of planning, execution, reporting and follow up audit.

5. Findings and Discussion

This study chooses single main case study as its research approach based on its extreme criteria as being among the earliest Islamic bank in Malaysia and outstanding achievements over the years. This bank plays a pivotal role in building viable Islamic banking system that would function in parallel with conventional banking. Preliminary study findings had revealed that Shariah audit personnel have already been appointed even before the announcement of SGF. In addition, the bank has gone through many changes since its establishment, which includes its Shariah governance. Findings from preliminary study have also found that internal Shariah audit function of the bank applies International Professional Practices Framework (IPPF) issued by the Institute of Internal Auditor (IIA). The Council of Malaysian Institute of Accountants (MIA) had approved the adoption of IPPF as a guide for members who are involved in internal audit work. Internal control is designed to assist institutions in achieving their objectives. Internal Shariah audit function is also guided by the Committee of Sponsoring Organizations (COSO). The bank's Shariah audit function also uses RBIA as a methodology that links internal auditing to the bank's overall risk management framework. Participants of this study are referred to as Participant A, B and C accordingly.

5.1. Shariah Audit Planning

Shariah audit planning is important to ensure Shariah compliance many aspects, especially on high-risk audit areas. As conventional internal audit is currently adopting risk-based audit, identification of high, medium, and low risk for every audit area is considered to be crucial. With this respect, high-risk activity includes the process of preparing product manuals, as well as preparation of legal documentation and marketing activities. Preparation of Shariah audit plan requires proper risk assessment process. Shariah risk is defined by SGF to be as follows:

"Shariah risk is possible failures to comply with Shariah principles/requirements or in other words possible incidences of Shariah non-compliance" (Bank Negara Malaysia, 2011).

Proper risk assessment is hence important to assist the preparation of Shariah audit plan. An audit plan will be able to guide auditors on the focus area of audit. Participant B has highlighted the importance of Shariah audit planning, stating that:

"The important part is planning. We need to make it clear on what our focus is. What is the most critical? Failure at the planning part of audit will contribute to the failure of site visit".
(Participant B)

In order to determine the focus area during audit execution, the Bank develops two types of Shariah audit plan. The first plan, Annual Audit Planning is prepared in the last quarter of financial year end, while Audit Assignment Planning is performed prior to the execution of individual audit fieldwork/assignment.

The process of annual audit planning begins with Shariah risk assessment on audit universe or audit centres, clients or departments. After the identification of audit universe, Shariah auditor will identify Shariah requirements to determine Shariah risk profile. These include all relevant rulings, such as rulings and decisions of Shariah Advisory Councils of Bank Negara Malaysia (BNM) and Securities Commission of Malaysia; guidelines issued by BNM and Securities Commission e.g. Shariah parameter; also other relevant and applicable pronouncement issued by BNM.

After that, Shariah risk profile will be grouped together according to their common risk area. Shariah risk areas include *Aqad* execution (touch-point), product structure, product development, product documentations and dress code.

Participant A had explained in detail on Shariah risk profile. He stated that:

"We identify audit universe, department and processes to check. We also identify Shariah requirements and rulings. Then I will group the risk profile into common risk area. And then, I will match those requirements with audit universe, I prioritize the audit centre".
(Participant A)

Determination of audit area prioritization would depend on the assessed risk. The focus of auditor will be placed more on high-risk areas. Consequently, the auditor's decision is justified and the selection of area is done specifically. After assessment of Shariah risk and development of Shariah risk profile, Shariah auditor will next prepare Shariah audit program for each audit universe. Participant A mentioned that:

"We will develop risk profile together with Shariah audit program. We will write audit program based on profiling".
(Participant A)

Shariah auditor will then determine the number of audit assignment that needs to be conducted throughout the next 12 months (based on risk factors and audit resources available) after the development of audit program. Afterwards, the audit assignment is tabled to Audit Committee and SC for approval and adoption. As mentioned by Participant A:

"We determine the number of assignments for next twelve months and then we table it to Audit Committee and Shariah committee".
(Participant A)

The second type of Shariah audit plan is Audit Assignment Planning. It begins with reassessment of Shariah risk on each audit centre to be audited. Next, auditors would determine an area of audit to be prioritized, in addition to the type of resources and expertise required to carry out the audit exercise. Later, audit fieldwork period and scope of Shariah audit are determined. Finally, the auditor would obtain authorisation from the Chief Internal Auditor. The number of assignments planned for a year has to take into consideration the resources available to the auditor. As Participant A has commented, the Bank conducts approximately six assignments in six months.

"Normally, one assignment takes about a month".

(Participant A)

In the process of preparing audit plan, Shariah auditor would also obtain advice from other internal party, such as Shariah risk department and Shariah review department. The team will also obtain information from operational auditor in order to prepare their audit plan so that proper coverage is done on all necessary areas or branches. In addition, there are also informal communications with regards to the audit area between auditors with other functions, such as Shariah review procedures.

As previously explained, audit planning process shows that audit is performed more frequently to high-risk area. It is clear that an evolution towards higher levels of risk-based auditing is absolutely needed if internal auditors seek to play an important role in risk management (Hawkamah, 2011; Sarens and De Beelde, 2006). Three main components in risk-based Shariah audit methodology are critical with regards to Shariah risk exposure, quality adequacy control and risk mitigation. This is confirmed by Participant A as below:

"We look at three components. One, criticality of Shariah risk exposure. Later, after we know the risk, we will look at the quality adequacy control and risk mitigant. How they manage that risk and then how management of risk is in totality to minimize potential loss".

(Participant A)

Participant A further explained that:

"We use risk-base. What we do is we analyse risk first. Department with risk from the risky audit universe is considered as having higher risk. We will perform audit more frequent than less risky department".

(Participant A)

Preparation of audit plan and audit program is justified using risk-based approach. The focus is placed more on areas that have higher risk. It also takes into consideration elements in COSO internal control components, such as control environment, risk assessment, control activities, information and communication, as well as monitoring.

Application of risk-based approach is also applicable in operational audit. However, in Shariah audit function; there are differences in terms of objectives, requirements and the assessed risk. A clear objective of Shariah audit is required to give assurance as to whether all activities are in compliance to Shariah. Compliance to Shariah is the ultimate objective for IB. This objective is different as compared to operational audit objectives. Therefore, all actions involved in the planning process and preparation of audit program must be developed accordingly to achieve Shariah compliance. Despite that, there are still some similarities found in terms of tools and methodology used.

Participant B had explained that there are not much difference between Shariah audit activities and other audit activities, such as compliance, operations, credit and management. All these activities share the same methodology. This is similar to IIA's professional discipline, which allows for quick assimilation of professional auditors to cross over and carry out effective Shariah audit. Because of this, the Bank is moving forward in adopting international auditing standards with implementations of Shariah audit. Adaptation of international standards, which are based from conventional practices, is considered to be acceptable by the Bank.

5.2. Shariah Audit Execution

There are two types of Shariah audit which are executed in the Bank. The first is executed on "standalone" basis, while the second one is jointly executed with operations, credits, head office and subsidiary audit. Audit execution on standalone basis means that one audit execution is conducted for one whole department. Participant A stated that:

"Stand alone means staff that specialises in Shariah will do Shariah risk assessment. We go to one department. We will review the whole process. We identify risk and then we come out with risk profile and audit program".

(Participant A)

In the Bank, operational auditor does not perform Shariah audit. Similarly, operational audit does not include any audit on Shariah regulations. For subsidiaries however, the two audits are jointly executed. If by any chance non-compliance is detected during audit, both operational and Shariah auditors will take action on it. When operational auditor finds any Shariah non-compliance while performing their tasks, they will inform Shariah auditor to take further action. Similar action is taken when Shariah auditor finds any issues on operational aspects, in which they will inform the operational auditor. Their objective is hence to ensure compliance towards all rulings that have been set beforehand. Participant A had further explained on "subsequent audit" as follows:

"We use workforce of branch auditors to help us do the checking. But, we will guide, give checklist and training".

(Participant A)

If there is a need to perform audit on more complex issues, Shariah auditor will go and perform the audit. Audit sampling is hence done randomly, depending on available audit resources. As stated by Participant A:

“We choose randomly, the transactions. Regardless of a million transactions or hundreds transactions, one thousand, we take accordingly to our capacity.”
(Participant A)

In terms of the use of audit tools and methodology, Shariah audit uses similar tools with operational audit, as practised in the bank. This is mentioned by Participant C as follows:

“It is recommended to use industrial international practice. Actually, it is already available. So, we use that as a basis of our audit tools and methodology. It is because it is accepted internationally”.
(Participant C)

These audit tools and techniques include examination of documents, interviews, observations, questionnaires, walkthroughs and data mining. In the execution of Shariah audit practices, the bank applies COSO in internal audit practices. All participants realize the benefit of COSO as an effective audit methodology as it covers all aspects in ensuring effective internal control of the bank. Application of COSO in Shariah audit methodology also helps in achieving good risk management of the Bank. Shariah risk management is part of ERM for the bank. Shariah audit function in the third line of defence contributes to the effectiveness of the bank's ERM when they perform audit execution. Audit function needs to appreciate the availability of new method, which will be able to enhance its roles and responsibilities.

5.3. Shariah Audit Reporting and Follow-up Audit

Audit findings are discussed with respective auditees for further clarification and justification. This is important for auditees so that they are able to plan for any remedial actions. Furthermore, in order to deal with any state of discomfort or disagreements with auditees, Participant A explained:

“When I give recommendations, they will accept, discuss and come out with solution”.
(Participant A)

In terms of reporting, there are separate reports prepared for operational audit and Shariah audit. Each report is prepared according to its own objectives. The objectives of Shariah audit report includes among others; (i) to report Shariah non-compliance or potential Shariah non-compliance events/activities/transactions, (ii) to highlight causal factor that leads to Shariah non-compliance, (iii) to assess the degree of risk and its impact to the bank as a whole, (iv) to recommend corrective actions and improvements, (v) to suggest timelines for rectifications, and (vi) to conclude the state of internal control system and risk management process.

Shariah audit report can be used as a reference for SC to conclude on Shariah compliance of the bank. Shariah audit report would also benefit Shariah risk management, especially in situations where auditors need to prepare their Risk and Control Self-Assessment (RCSA). Participant D indicated that:

“Shariah audit report and Shariah review report. These two reports will be used when we want to prepare RCSA.”
(Participant D)

Shariah audit report can also add value to existing practices. Participant E explained that the quality of report is improving as compared to the report that has been prepared previously. He said that:

“Previously, I think too finding oriented. Now, we are more value added”.
(Participant E)

With these improvements, reports need to be carefully prepared by auditors to ensure the quality and reliability of internal Shariah audit work. This is consistent with Khalid *et al.* (2017), who argued that there is positive relationship between internal Shariah audit work performances (including communicating results) and internal Shariah audit effectiveness. Auditor should use his knowledge and understanding in providing his report because the report is going to be used by SAC for further deliberation and action. All related evidences must be carefully examined with reference to all relevant standards and guidelines. The nature of incompliance must be studied to determine the impact of identified risk to the *maslahah* or public interest. This hence requires auditors to be competent and qualified.

Preparation of Shariah audit report follows the guidelines provided in SGF. SGF states that the process of Shariah audit includes communicating results of any assessment or findings arising from Shariah audit to the Audit Committee and SC. Shariah audit report is then tabled to the Audit Committee. The report is later extended to SC for deliberation and further action. Any deliberation indicating corrective actions to risk management efforts is extended to the Head of respective audit centre for further action. This is in line with requirements of Shariah non-compliance reporting in Islamic Financial Services Act (IFSA) 2013. Section 28 (3) of IFSA 2013 explains on the action that should be taken by the bank when there is any occurrence of Shariah non-compliance event. SGF further states in Section 2.17 that:

“In the event the management becomes aware that certain operations are found to be carrying out businesses which are not in compliance with Shariah, or against the advice of the SC or the rulings of SAC, the management shall immediately notify the board and SC as well as Bank Negara Malaysia.”

The last step in Shariah audit process is the follow-up audit. Shariah auditor would continuously perform the audit until the arising issue is fully resolved. It begins with tracking rectification efforts from Shariah Non-Compliance Tracking Report. Afterwards, SC or sub-committee and risk control function would oversee the rectification effort. Shariah audit function will perform follow-up audit on monthly basis to ensure that the

concerning issue is fully resolved. Auditors would allocate certain timeframe for the auditee to make rectification and follow-up audit in order to ensure Shariah compliance.

6. Conclusion

Empirical data in this case study had presented four internal Shariah audit processes, namely planning, execution and reporting and follow-up. It can be concluded that audit process of internal Shariah audit practices is similar to operational audit process and methodology. The differences are the objectives and type of risk ascertained. Internal Shariah audit function of the studied Bank uses RBIA and COSO. Three interrelated main components of RBIA include criticality of Shariah risk exposure; quality or adequacy of controls and risk mitigant in place; as well as management of Shariah risk in minimizing potential loss. Examination on those three components had enabled auditors to perform comprehensive and effective audit examination as more focus is given on high-risk areas. It is also important to have comprehensive audit which covers end to end process of audit. Moreover, Shariah audit function should consider an analysis beyond written and established criteria from authoritative bodies, such as achievement of Maqasid al Shariah or objective of Shariah. Notably, audit objectives and assessed risks are different in comparison to operational audit practices. Any decisions made on Shariah issues would depend on deliberation of the highest Shariah authority in the bank, which is SC. This is where independence and credibility of SC is essential, as stakeholders will rely on their report on Shariah compliance for decision-making purposes.

Finally, it is also interesting for future researches to examine whether stakeholders of IBs are able to identify the difference between full scope audits and limited scope audits by the way they are currently reported and presented. Findings from this research suggest that very often the scope of *Shariah* audit is limited only to *Shariah* product compliance. In addition, unstructured procedures and non-uniformity in audit process in many IBs may result to the inability to make comparisons of the Shariah compliance report by stakeholders. This may hinder sound decision-making by them. It would therefore be useful for future researches to also examine on communication value, as well as the content and format of *Shariah* audit reports.

Acknowledgement: The authors thank all participants of this research and appreciate the sponsorship obtained from Institute of Quality and Knowledge Advancement, Institute of Research Management, Accounting Research Institute and Ministry of Higher Education to enable this research to be carried out.

Acknowledgement

We wish to thank all participants of this research and appreciate the funding obtained from Institute of Quality and Knowledge Advancement and Ministry of Higher Education.

References

- Al-Sharairi, J. A. and Alsharayri, M. A. (2012). The operating Islamic banks in Jordan applying the International Internal Auditing Standards, IIA's *International Journal of Economics and Finance*, 4(2): 232–43.
- Bangash, A. J. (2012). Significance of Shariah audit and compliance in Islamic banks. Available: <http://www.halaltamweel.com/2012/04/18/News/Significance-of-Shari-a-Audit---Compliance-in-Islamic-Banks/4720/Story.asp>
- Bank Negara Malaysia (2005). Guidelines on financial reporting for licensed Islamic banks (GP8-i).
- Bank Negara Malaysia (2011). Shariah governance framework for Islamic financial institutions. Available: <http://www.bnm.gov.my>
- Castanheira, N., Rodrigues, L. L. and Craig, R. (2010). Factors associated with the adoption of risk-based internal auditing. *Managerial Auditing Journal*, 25: 79–98. Available: <http://doi.org/10.1108/02686901011007315>
- Creswell, J. W. (2012). *Educational research: planning, conducting, and evaluating quantitative and qualitative research*. (P. A. Smith, Ed.). 4th edn: Pearson Education: Boston.
- Creswell, J. W., Hanson, W. E., Clark Plano, V. L. and Morales, A. (2007). Qualitative research designs: Selection and implementation. *The Counseling Psychologist*: Available: <https://doi.org/10.1177/0011000006287390>
- DeLorenzo, Y. T. (2010). Shari'ah supervision in modern Islamic finance. Available: <http://www.nzibo.com/IB2/Shari'ahsupervision.pdf>
- Flyvbjerg, B. (2006). Five misunderstandings about case study research. *Qualitative Inquiry*, 12(2): 219–45. Available: <http://qix.sagepub.com/cgi/doi/10.1177/1077800405284363>
- Hassan, R., Arifin, M., Othman, A. A., Napiyah, M. D. M., Omar, M. N. and Yusoff, A. (2014). An empirical study of the effectiveness of Shariah Governance Framework (SGF 2010). ISRA Research Paper. 68.
- Hawkamah (2011). *Policy brief on corporate governance for Islamic banks and financial institutions in the Middle East and North Africa Region*. Hawkamah, The Institute for Corporate Governance: Dubai.
- Hussan, S. M., Karim, F. M. A. and Manap, A. N. (2013). Instituting Shariah audit in Malaysian Islamic financial institutions. *ISRA. International Journal of Islamic Finance*, 5(2).
- Islamic Banker Asia (2014). Islamic finance in Asia, Promising prospects. *Islamic Banker Asia*: 16–19.
- Kasim, N., Ibrahim, S. H. M. and Sulaiman, M. (2009). Shariah auditing in Islamic financial institutions, Exploring the gap between the “desired” and the “actual”. *Global Economy and Finance Journal*, 2(2): 127–37. Available: http://www.wbiconpro.com/6%5B1%5D.-Nawal_latest.pdf
- Khalid, A. A., Haron, H. H. and Masron, T. A. (2017). Relationship between internal Shariah audit characteristics and its effectiveness. *Humanomics*, 33(2): 221–38.

- Mohiuddin, M. (2012). Auditing: conventional and divine perspective. *Research Journal of Finance and Accounting*, 3(9): 101–08. Available: <http://iiste.org/Journals/index.php/RJFA/article/view/3155>
- Onagun, A. I. and Mikail, A., 2013. "Shariah governance system: A need for professional approach." In *Sharia Economics Conference*. pp. 71–80.
- Pricewaterhousecoopers (2007). Internal Audit 2012 Asia Pacific Supplement.
- Rahman, A. R. A. (1998). Issues in corporate accountability and governance: an Islamic perspective. *American Journal of Islamic Social Sciences*: Available: http://i-epistemology.net/attachments/618_V15N1Spring98-AbdulRahman-IssuesinCorporateAccountabilityandGovernance-AnIslamicPerspective.pdf
- Rahman, A. R. A. (2008). Shari'ah audit for Islamic financial services, The needs and challenges. *ISRA Islamic Finance Seminar*, (November): Available: <http://scholar.google.com/scholar?hl=en&btnG=Search&q=intitle:AUDIT+FOR+ISLAMIC+FINANCIAL+SERVICES+:+the+needs+and+challenges#0>
- Rahman, A. R. A. (2011). Enhancing the integrity of Islamic financial institutions in Malaysia, The case for the Shariah audit framework. *ISRA International Journal of Islamic Finance*, 3(1).
- Rosly, S. A. (2010). Shariah parameters reconsidered. *International Journal of Islamic and Middle Eastern Finance and Management*, 3(2): 132–46. Available: <http://doi.org/10.1108/17538391011054372>
- Sarens, G. and De Beelde, I. (2006). The relationship between internal audit and senior management: a qualitative analysis of expectations and perceptions. *International Journal of Auditing*, 10: 219–41. Available: <http://doi.wiley.com/10.1111/j.1099-1123.2006.00351.x>
- Shafii, Z., Salleh, S. and Shahwan, S. (2010). Management of Shari'ah non-Compliance audit risk in the Islamic financial institutions via the development of Shari'ah compliance audit framework and Shari'ah audit programme. *Kyoto Bulletin of Islamic Area Studies*, 3(2): 3–16. Available: http://www.asafas.kyoto-u.ac.jp/kias/1st_period/contents/pdf/kb3_2/04shafii.pdf
- Shafii, Z., Salleh, S., Hanefah, M. M. and Jusoff, K. (2013). Human capital development in Shariah audit. *Middle-East Journal of Scientific Research*, 13: 28–34.
- Triyanta, A. and Rusni, H. (2011). The process of Shariah assurance in the product offering, Some important notes for Indonesian and Malaysian Islamic banking practice. *Islamic Economic Studies*, 18(1): 19–50.
- Yaacob, H. and Donglah, N. K. (2012). Shari'ah audit in islamic financial institutions: The postgraduates' perspective. *International Journal of Economics and Finance*, 4(12): Available: <http://www.ccsenet.org/journal/index.php/ijef/article/view/22128>
- Yahya, Y. (2018). A review of Shariah auditing practices in ensuring governance in Islamic financial institution (IFIs) – A preliminary study. *Advances in Social Sciences Research Journal*, 5(7): 196–210.
- Yahya, Y. and Mahzan, N., 2012. "The role of internal auditing in ensuring governance in Islamic financial institution (IFI)." In *3rd International Conference on Business and Economic Research (3rd ICBER 2012) Bandung*. pp. 1634–61.
- Yin, R. K. (2003). *Case study research, Design and methods*. 3rd edn: Sage Publications: Thousand Oaks. 5.