



**AN ANALYSIS OF SHARI'AH AUDIT PRACTICES IN  
ISLAMIC BANKS IN MALAYSIA**

**BY**

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## **ABSTRACT**

Shari'ah audit is an important element to ensure Shari'ah compliance in Islamic banking operations. Currently in Malaysia, each Islamic bank and financial institution is required by the Shari'ah Governance Framework to establish the Shari'ah audit function to provide reasonable assurance and ensure an effective internal control system for Shari'ah compliance. At the moment, there is lack of empirical studies conducted to ensure proper practice of the Shari'ah audit in Islamic banks in the absence of a Shari'ah audit framework. The primary objective of this research is to determine the extent of Shari'ah audit practices in Islamic banks in Malaysia. The study also evaluates the supervisory and practical challenges in the implementation of Shari'ah audit practices. The research adopts the mixed method approach consisting of a survey questionnaire and structured interviews. Survey questionnaires were distributed to the heads of Shari'ah audit, internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members of 16 Islamic banks in Malaysia. The study conducts structured interviews with the Shari'ah Committee members in selected Islamic banks. The study adopts the Exposure Draft of Internal Shari'ah Audit Framework (ISAF) issued by the International Shari'ah Research Academy (ISRA) as a benchmark to measure the extent of Shari'ah audit practices. From the findings, the results indicate that almost all Islamic banks have established the audit objectives, governance structure, competency of internal Shari'ah auditors, audit process and reporting requirements as part of their Shari'ah audit practices. However, some Islamic subsidiaries have excluded audit scope and audit charter. Also, internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members agreed that it is important to develop a proper structure for the Shari'ah audit function in Islamic banks. The study found that Shari'ah Committee members understand Shari'ah audit in terms of ensuring Shari'ah compliance, the need to ensure competency of internal Shari'ah auditors and the need to have audit guidelines. They also faced challenges such as to supervise Shari'ah audit findings, to determine Shari'ah audit work and to conduct an internal Shari'ah audit. In conclusion, the good Shari'ah audit practices in Islamic banks have constituted a positive development in enhancing the integrity of Islamic banks. This further highlights the need for Bank Negara Malaysia to establish a standard Shari'ah audit framework in Malaysia.

## ملخص البحث

يعتبر التدقيق الشرعي آلية مهمة لضمان توافق العمليات البنكية في البنوك الإسلامية مع أحكام الشريعة الإسلامية، وهي آلية باتت مفروضة هنا في ماليزيا من طرف الحكومة على كافة البنوك التي تقدم خدمات بنكية وفق الشريعة الإسلامية وذلك لضمان وتفعيل نظام المراقبة الشرعية الذاتية في كل بنك على حدا. لكن مع كل هذه الجهود يلاحظ وجود نقص في الدراسات التطبيقية التي أجريت لضمان الممارسة السليمة لهذه الآلية في ظل عدم وجود إطار موحد لهذه الآلية يمكن تعميمه على كافة البنوك. تهدف هذه الدراسة لتحديد مدى وحدود تطبيقات التدقيق الشرعي في البنوك الإسلامية، وتعرض الدراسة للتحديات الرقابية والعملية التي تعيق عمل آلية التدقيق الشرعي. و تعتمد الدراسة المنهج المزدوج الذي يعتمد على الدراسة المسحية من خلال جمع البيانات عن طريق الاستبيانات، وإجراء المقابلات الحصرية، فبالنسبة للاستبيانات فقد وزعت على رؤساء خلية التدقيق الشرعي، والمدققين الشرعيين الداخليين، والمديرين التنفيذيين لوحدة الخدمات البنكية الإسلامية وأعضاء الهيئة الشرعية في 16 بنكا إسلاميا في ماليزيا، بينما أجريت المقابلات مع أعضاء الهيئات الشرعية في كافة البنوك المختارة. ومن حيث المرجعية فالدراسة تعتمد على مسودة العرض الداخلي لإطار التدقيق الشرعي ISAF الصادرة على الأكاديمية العالمية للبحوث الشرعية ISRA كمؤشر لقياس مدى ومستويات التدقيق الشرعي. وصلت الدراسة إلى جملة من النتائج منها أن أغلب البنوك الإسلامية قطعت خطوات هامة في تحقيق أهداف التدقيق الشرعي من حيث الهيكل الإداري وكفاءة مراجعي الحسابات الداخلية مع أحكام الشريعة الإسلامية مع توفر عملية المراجعة، ومتطلبات إعداد التقارير كجزء من ممارستها للتدقيق الشرعي. إلا أنها وقفت على حالات استبعدت فيها بعض الفروع الإسلامية نطاق التدقيق و ميثاق التدقيق الشرعي. ومن خلال تحليل الاستبيانات فقد اتفق المدققون الشرعيون الداخليون والمديرون التنفيذيون لوحدة الخدمات البنكية الإسلامي وأعضاء الهيئة الشرعية على وجوب إيجاد آلية مناسبة وفعالة لعملية التدقيق الشرعي في البنوك الإسلامية، كما نوه مراجعو الحسابات الداخلية مع أحكام الشريعة الإسلامية، والمديرون التنفيذيون وأعضاء اللجنة الشرعية على وجوب وضع الهيكل المناسب لوظيفة التدقيق الشرعي في المصارف الإسلامية. كما وقفت الدراسة على الحاجة الملحة لضمان الكفاءة في المدققين الشرعيين داخل كل بنك، أيضا الحاجة إلى دليل موحد توجيهي لعملية التدقيق الشرعي، كما وقفت الدراسة على بعض المشاكل التي تعرقل هيئة الرقابة الشرعية مثل أهلية الإشراف على نتائج المراجعة الشرعية. وفي الختام فقد شكلت ممارسات التدقيق الشرعي في المصارف الإسلامية تطورا إيجابيا في تعزيز سلامة المصارف الإسلامية. مما يلقي مزيدا من الضوء على دور البنك المركزي في ضرور إيسرا بإنشاء إطار موحد للمراجعة الشرعية في كافة البنوك الإسلامية الماليزية.

## **APPROVAL PAGE**

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Islamic Banking and Finance .

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## DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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## TABLE OF CONTENTS

Abstract .....	ii
Abstract in Arabic .....	iii
Approval Page .....	iv
Declaration Page .....	v
Copyright Page .....	vi
Acknowledgements .....	vii
List of Tables .....	xi
List of Abbreviations .....	xiii
<b>CHAPTER ONE: INTRODUCTION .....</b>	<b>1</b>
1.1 Background of the Study .....	1
1.2 Problem Statement .....	4
1.3 Research Objectives and Questions .....	6
1.4 Contributions of the Study .....	8
1.5 Organisation of Research .....	9
<b>CHAPTER TWO: LITERATURE REVIEW .....</b>	<b>10</b>
2.1 Introduction .....	10
2.2 Principles and Practices of Auditing and Governance .....	10
2.2.1 Theories of Auditing and Governance .....	12
2.2.1.1 Agency Theory .....	12
2.2.1.2 Accountability Theory .....	13
2.2.1.3 Stakeholder Theory .....	14
2.2.2 Audit Practices and Governance .....	16
2.2.3 Past Studies in the field of Auditing and Governance .....	19
2.3 The Islamic Banking Industry in Malaysia .....	21
2.3.1 History of Islamic Banking in Malaysia .....	22
2.3.2 Principles and Philosophy of Islamic Finance .....	25
2.3.3 Regulatory Challenges of Islamic Banking Industry .....	27
2.3.4 Corporate and Shari'ah Governance of Islamic Banks .....	29
2.4 Shari'ah Auditing .....	31
2.4.1 Definition of Shari'ah Audit .....	32
2.4.2 Needs for Shari'ah Audit in Islamic Banks .....	33
2.4.3 Past Studies on Shari'ah Audit .....	34
2.5 Exposure Draft of Internal Shari'ah Audit Framework .....	40
2.6 Conclusion .....	46
<b>CHAPTER THREE: RESEARCH METHODOLOGY .....</b>	<b>48</b>
3.1 Introduction .....	48
3.2 Research Objectives .....	48
3.3 Research Questions .....	50



3.3.1 Research Objective No.1 – The Extent of Shari’ah Audit Practices in Islamic Banks in Malaysia.....	52
3.3.2 Research Objective No.2 – The Views on the Functions of Shari’ah Audit .....	52
3.3.3 Research Objective No.3 – Supervisory and Practical Challenges .....	53
3.4 Research Design .....	54
3.4.1 Mixed Methods Research.....	55
3.4.2 Exploratory Study .....	56
3.5 Data Collection Method.....	58
3.5.1 Population and Sample.....	58
3.5.2 Survey Questionnaires .....	64
3.5.2.1 Questionnaire Design .....	65
3.5.2.2 Pilot Study .....	70
3.5.2.3 Distribution of Survey Questionnaires .....	70
3.5.3 Interview .....	72
3.5.3.1 Organising Personal Interview .....	73
3.6 Data Analysis Method .....	74
3.6.1 Measurement of Shari’ah Audit Practices.....	74
3.6.2 Descriptive Statistical Analysis .....	81
3.6.3 Validity Test.....	83
3.6.4 Reliability Test .....	84
3.6.5 Interview Data Analysis.....	85
3.7 Conclusion .....	86
<b>CHAPTER FOUR: FINDINGS AND ANALYSIS .....</b>	<b>87</b>
4.1 Introduction.....	87
4.2 Responses Rate .....	87
4.3 Validity and Reliability Test.....	89
4.4 Demographic Analysis .....	90
4.5 Research Findings.....	97
4.5.1 Research Objective No.1 – The Extent of Shari’ah Audit Practices in Islamic Banks in Malaysia.....	99
4.5.2 Research Objective No.2 – The Views on the Functions of Shari’ah Audit .....	113
4.5.3 Research Objective No.3 – Supervisory and Practical Challenges .....	128
4.5 Conclusion .....	141
<b>CHAPTER FIVE: CONCLUSION.....</b>	<b>143</b>
5.1 Introduction.....	143
5.2 Summary of Research Findings.....	143
5.2.1 The Extent of Shari’ah Audit Practices in Islamic Banks in Malaysia .....	144
5.2.2 The Views on the Functions of Shari’ah Audit.....	145
5.2.3 Supervisory and Practical Challenges .....	147
5.3 Contributions of Study.....	147

5.3.1 Theoretical Contributions .....	148
5.3.2 Methodological Contributions .....	149
5.3.3 Policy Implications .....	150
5.4 Limitations of the Study .....	152
5.5 Suggestions for Future Research .....	153

<b>BIBLIOGRAPHY .....</b>	<b>154</b>
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<b>APPENDIX 1: Questionnaire Survey Set 1.....</b>	<b>162</b>
<b>APPENDIX 2: Questionnaire Survey Set 2.....</b>	<b>170</b>
<b>APPENDIX 3: Interview Guideline .....</b>	<b>180</b>
<b>APPENDIX 4: Summary of Shari’ah Audit Practices .....</b>	<b>182</b>
<b>APPENDIX 5: Detailed Mean Comparison .....</b>	<b>186</b>

## LIST OF TABLES

<u>Table No.</u>		<u>Page No.</u>
2.1	List of Islamic Banks	25
3.1	Research Questions	51
3.2	List of Licensed Islamic banks in Malaysia	59
3.3	Distribution and Response of the Survey Questionnaires	62
3.4	Type of Islamic Banks	63
3.5	Summary of Target Respondents	64
3.6	Contents of the survey questionnaire (set 1)	67
3.7	Contents of the survey questionnaire (set 2)	69
3.8	Scope of Internal Shari'ah audit	77
3.9	Thematic analysis of Interview Data	86
4.1	Responses received from Survey Questionnaire	88
4.2	Results of Reliability Test	90
4.3	Designation of Respondents	91
4.4	Respondents' Gender	91
4.5	Respondents' Age	92
4.6	Respondents' Education	93
4.7	Respondents' Years of Experience and Duration of Service in Current Islamic Bank	94
4.8	Current Structure and Frequency of conducting Shari'ah audit in Islamic Banks	95
4.9	Summary of Practices – Audit of financial statements of the IFIs	100

4.10	Summary of Practices – Compliance audit on organisational structure, people, process and information technology applications systems	103
4.11	Summary of Practices – Review of adequacy of Shari’ah governance process	107
4.12	Summary of Shari’ah Audit Practices	108
4.13	Summary of Means Scores for each component in the functions of Shari’ah Audit	114
4.14	Summary of Result for Kruskal-Wallis test	119
4.15	Summary of correlation coefficient value between level of highest education and the components for the functions of Shari’ah audit	121
4.16	Summary of correlation coefficient value between working experience and the components for the functions of Shari’ah audit	124
4.17	Summary of correlation coefficient between duration of service and functions of Shari’ah audit	126

## LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organisations for Islamic Financial Institutions
ACCA	Association of Chartered Certified Accountants
ANOVA	Analysis of Variance
BIB	Bahrain Islamic Bank
BIMB	Bank Islam Malaysia Berhad
BNM	Bank Negara Malaysia
e.g.	for example
IAH	Investment Account Holders
IB	Islamic Bank
IBFIM	Islamic Banking and Finance Institute Malaysia
IDB	Islamic Development Bank
IFI	Islamic Financial Institution
IFSA	Islamic Financial Service Act of 2013
IIA	Institute of Internal Auditors
INCEIF	International Centre of Education in Islamic Finance
IPPF	International Professional Practices Framework
ISAF	Internal Shari'ah Audit Framework
ISRA	International Shari'ah Research Academy
i.e.	that is
MASB	Malaysian Accounting Standard Board
MFRS	Malaysia Financial Reporting Standards
OECD	Organisation for Economic Co-operation and Development
PLS	Profit and Loss Sharing
ROA	Return on Assets
ROE	Return on Equity
RQ	Research Question
SGF	Shari'ah Governance Framework
Sig.	Significant
SOP	Standard Operating Procedures
SOX	Sarbanes-Oxley Act of 2002

# CHAPTER ONE

## INTRODUCTION

### 1.1 BACKGROUND OF THE STUDY

The growth of Islamic banking and financial institutions in Malaysia began in 1969 with the establishment of the Pilgrim Fund Board or ‘Tabung Haji’ as the first Islamic savings institution. Later, in 1983, Bank Islam Malaysia Berhad (BIMB) was established as the first Islamic bank in Malaysia (International Shariah Research Academy (ISRA), 2011b). This milestone achievement paved the way for the establishment of other full-fledged Islamic banks. In addition, conventional banks were permitted to set up Islamic banking subsidiaries. Currently in Malaysia, there are 16 licensed Islamic banks operating under the auspices of Bank Negara Malaysia (BNM) (Bank Negara Malaysia, 2012a). These Islamic banks are mandated to operate according to Shari’ah principles. This is a fundamental requirement as stakeholders participating in Islamic banking activities expect more from Islamic banks<sup>1</sup> (IBs), especially in terms of Shari’ah compliance. In this respect, Islamic banks are required by the Shari’ah Governance Framework<sup>2</sup> (SGF) to establish the Shari’ah audit function to provide the assurances for Shari’ah compliance in Islamic banking operations (Bank Negara Malaysia, 2012b). However, Islamic banks in Malaysia risk losing their license, or worse yet, their credibility, as the Shari’ah audit function in

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<sup>1</sup> IBs stand for Islamic banks which refer to a system of banking that complies with the Shari’ah principles. Islamic banking adopts the principle of mutual risk, profit sharing between parties; assurance of fairness for all and transactions are based on underlying business activity or asset (Bank Negara Malaysia, 2013b).

<sup>2</sup> Shari’ah Governance Framework (SGF) is established by Bank Negara Malaysia to enhance the role of the board, Shari’ah Committee and management in relation to Shari’ah matters, including enhancing the relevant key organs that are responsible to execute Shari’ah compliance and research functions aimed at achieving Shari’ah-based environment.

Islamic Financial Institutions<sup>3</sup> (IFIs) has yet to be employed as an important monitoring tool for Shari'ah compliance (Kasim, Mohamad Ibrahim, & Sulaiman, 2009).

The lack of internal Shari'ah audit practices in Islamic banks in Malaysia are mainly due to the different understanding among internal Shari'ah auditors over the ways to perform a Shari'ah audit (Yahya & Mahzan, 2012) and the absence of an internal Shari'ah audit framework in Malaysia (Yussof, 2013). Although the Accounting and Auditing Organisations for Islamic Financial Institutions (AAOIFI) has issued the Auditing Standard for Islamic Financial Institutions No.1, this auditing standard is not mandatory for IFIs in Malaysia. This is because, the IFIs in Malaysia must comply with the regulations and standards provided by BNM, Companies Act 1965, Malaysian Accounting Standard Board (MASB) and Malaysian Financial Reporting Standards (MFRS). However, there is no specific Shari'ah audit framework issued by BNM to perform the Shari'ah audit.

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

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<sup>3</sup> IFIs stand for Islamic financial institutions which refer to the financial institutions that offers Islamic banking products and services (International Shariah Research Academy (ISRA), 2011b).

of people (Chapra, 2008) and achieving the socio-economic objectives of the society (Mohamed Ibrahim, 2005).

Until today, few issues still arise in the operations of Islamic banks and financial institutions in Malaysia. The criticisms not only arise in terms of the Islamic banking products such as Bay' al-Inah, Tawarruq and Sukuk (Khan, 2012), but also the integrity of IFIs have been questioned as Shari'ah audit is not properly practice by IBs in Malaysia (Abdul Rahman, 2011). There is a lack of assurance in the whole system of IBs to enhance the confidence of stakeholders towards Shari'ah compliance. At this stage, IBs are also facing risk of Shari'ah non-compliance, which will affect the authenticity of its status as an Islamic bank in terms of its compliance towards the rules and principles of Shari'ah (Nik Sulaiman, 2012).

With regards to the issue of Shari'ah compliance and the high expectation among stakeholders in Islamic banking activities, the study acknowledges the importance and needs for the Shari'ah audit to enhance the stakeholders' value and confidence in terms of the stability and financial performance of IFIs (Abdul Rahman, 2008). In the context of the religious legitimacy of IFI's, scholars advocate the needs for Shari'ah audit as a mode of assurance that the operations of IFIs are Shari'ah compliant (Mohamed Sultan, 2009), ensure the right and proper conduct of its Shari'ah compliant activities (Kasim et al., 2009), assess the procedures of each products to ensure its compliance with Shari'ah principles (Shafii, Salleh, & Shahwan, 2010), and check the soundness of its internal control system (Shafii & Salleh, 2010).

The normal internal audit performed by a group internal audit division of the bank offers assurances concerning only the effectiveness of the internal control system in the IBs, whereas an internal Shari'ah audit offers additional criteria for assurances regarding matters pertaining to Shari'ah compliance (Haniffa, 2010). The assurances



afforded by means of a Shari'ah audit are not only restricted to the products offered by IBs. It also constitutes a mechanism for check and balance in terms of the process, procedures, organisational structure, operations, and the people and the environment of IFIs (Mohamed Sultan, 2009). Internal Shari'ah audits are needed because the current internal audit does not intend to provide reasonable assurances that their Islamic banking activities are Shari'ah compliant, thus failing to meet the needs of stakeholders in IBs (Haniffa, 2010).

## **1.2 PROBLEM STATEMENT**

Stakeholders nowadays need assurances on the integrity of Islamic banks and financial institutions in conducting Islamic banking activities in accordance with Shari'ah principles. Abdul Rahman (2011) argued that enhancing integrity is critical for all IFIs as the need is not only to pursue ethical finance, but more importantly, to ensure their operational and business activities comply with Shari'ah principles. Therefore, to provide such assurances of integrity, there is a need for the internal Shari'ah audit practices to co-exist with Shari'ah controls. Implementing a Shari'ah audit offers independent monitoring and control that assist towards ensuring the integrity of IFIs.

The study acknowledges that each Islamic bank and financial institution is respectively required by the Shari'ah Governance Framework (SGF) to establish the Shari'ah audit function as part of the internal audit division (Bank Negara Malaysia, 2012b). However, Bank Negara Malaysia (BNM) has yet to establish the Shari'ah audit framework as a standard guideline for all IBs in Malaysia. Currently in Malaysia, the group internal audit division in IBs follows the International Professional Practice Framework (IPPF) issued by the Institute of Internal Auditors

(IIA) and the Guideline on Minimum Audit Standards for Internal Auditors of Financial Institutions by BNM to perform internal audit works (Yussof, 2013). The absence of a Shari'ah audit framework may lead to a number of challenges in terms of Shari'ah audit practices. This is because each IB may have practised Shari'ah audit using its own auditing guideline or a modified conventional internal audit framework. Another challenge may arise in terms of gathering audit evidence, conducting a systematic Shari'ah audit program and producing an independent internal Shari'ah audit (Abdul Rahman, 2008). Moreover, Muhammad Sultan (2009) argued on the challenge to educate people and to create stakeholder awareness on the transparency of Islamic banking operations. The integrity of internal Shari'ah auditors can be questioned by the stakeholders if they are not independent in expressing their opinion towards the Shari'ah compliant activities in IBs (Kasim et al., 2009).

On the other hand, IBs have reached a critical stage in their development and must fulfil the high expectations of stakeholders towards Islamic banking activities. The shareholders who have invested in the business of IBs are interested to see that their investment has been ventured faithfully into a Shari'ah compliant business (Grais & Pellegrini, 2006a). Not only focusing on Islamic financial products, the Muslim public seek assurances that all Islamic banking operations are in line with Shari'ah principles. Reasonable assurance of Shari'ah compliance can be achieved from the opinions expressed by the internal Shari'ah auditors as derived from the Shari'ah audit process.

Previous researches in Shari'ah audit have looked into the needs and challenges (Abdul Rahman, 2008), perceptions of academicians and practitioners towards Shari'ah audit (Mulyany, 2008) and audit framework for Shari'ah compliance (Shafii et al., 2010). Also, a few studies done on the Shari'ah audit practices in Islamic

financial institutions in Malaysia only focused on the scope, competency, working practices and current framework used to perform Shari'ah audit (Kasim et al., 2009; Nik Sulaiman, 2012; Yahya & Mahzan, 2012). However, there is lack of empirical studies on the current practice of Shari'ah audit in IBs in Malaysia in the absence of a Shari'ah audit framework. In addition, there is currently no standard or guidelines to provide systematic assurance to boost the confidence of stakeholders and enhance the integrity of Islamic banks and financial institutions.

The objective of this research is to perform an empirical study to determine the extent to which IB's in Malaysia adopt Shari'ah audit practices. The study is unique as it adopts the Exposure Draft of Internal Shari'ah Audit Framework (ISAF) developed by ISRA (2011a), commissioned by BNM as the benchmark to examine the extent of Shari'ah audit practices in terms of audit scope, audit objectives, audit and governance, audit charter, competency of internal Shari'ah auditors, audit process and reporting requirements. The study does not intend to measure the compliance to the framework, as it has yet to be adopted by BNM. Apart from that, the study aims to obtain the views of the internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members on the functions of Shari'ah audit in IBs. Given the current practice of Shari'ah audit, the research needs to examine the perceptions of respondents who are directly and indirectly involved with Shari'ah audit practices in IBs. Also, the views of Shari'ah Committee members on the function of Shari'ah audit are sought as the most crucial external parties to the IBs.

### **1.3 RESEARCH OBJECTIVES AND QUESTIONS**

Given the above background of Shari'ah audit in IFIs, the study develops three research objectives as follows,

- i. To determine the extent of Shari'ah audit practices in IBs in Malaysia.
- ii. To examine the views of internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members on the function of Shari'ah audit in IBs in Malaysia.
- iii. To evaluate the supervisory and practical challenges in the implementation of Shari'ah audit practices across IBs in Malaysia.

The study attempts to answer the following research questions to obtain desired results for the above research objectives.

#### Research Questions 1

- a. What is the scope of audit outlined by the IBs?
- b. Do the IBs establish audit objectives, effective governance structure, specific audit charter, competency of internal Shari'ah auditors, audit process and proper reporting requirements in practising Shari'ah audit?

#### Research Questions 2

- a. What are the views of internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members on the function of Shari'ah audit in IBs in Malaysia?
- b. To what extent is there a difference in the views of internal Shari'ah auditors, Shari'ah executives and Shari'ah Committee members on the function of Shari'ah audit in IBs in Malaysia?
- c. Is there any association between the level of high education, work experience and duration of services in IBs among respondents and their views on the function of Shari'ah audit?

### Research Questions 3

- a. To what extent are the understandings of Shari'ah audit among Shari'ah Committee members?
- b. What are the observable improvements from the establishment of Shari'ah audit function in IBs?
- c. What are the challenges in supervising and monitoring Shari'ah audit works in IBs?
- d. What are the Shari'ah Committees' recommendations to improve Shari'ah audit practices?

#### **1.4 CONTRIBUTIONS OF THE STUDY**

The research aims to contribute to the field of Islamic banking and finance in Malaysia and related literature by exploring and comparing the practice of Shari'ah audit in each Islamic bank in Malaysia towards the development of a more comprehensive and standardised Shari'ah audit in Malaysia. Additionally, this research promotes greater awareness among Islamic banks and financial institutions of the current challenges in performing the Shari'ah audit and find ways in addressing those challenges. The findings of this research contribute towards the improvement of training for internal Shari'ah auditors to perform Shari'ah audit. This research may also help IBs to strategise the scope of works performed by the internal Shari'ah auditors. IBs need to ensure the independence of the internal Shari'ah auditors to avoid influence from management and the Shari'ah department of the banks when performing the Shari'ah audit.

As for the other stakeholders in IFIs, specifically the investors, depositors and shareholders, this study contributes towards a better understanding of the role of

Shari'ah audit in enhancing their confidence towards the integrity of IFIs. From the findings on the extent of Shari'ah audit practices in IBs, the stakeholders are informed of the level of assurances that ensure that IBs' activities meet Shari'ah principles. In all, this study remedies the problems of limited evidences on the extent of Shari'ah compliance in Islamic banking activities and lack of studies on Shari'ah audit practices in IBs.

## **1.5 ORGANISATION OF RESEARCH**

This research is organised into five chapters. The first chapter introduces the background of the study, problem statements, research objectives and questions, contributions and organisation of the research. Meanwhile, Chapter 2 reviews the past literatures written on Shari'ah audit. The literature review is divided into three parts starting with auditing and governance in general, followed by a discussion on the Islamic banking industry in Malaysia. The study then focuses specifically to the issue of Shari'ah auditing.

Chapter 3 discusses the research methodology including research objectives, target samples and the form of data analysis. Chapter 4 explains the research findings and the analysis from the survey questionnaires and structured interviews. Chapter 5 concludes the research with the summary of each research finding, and the major contributions of the research in terms of the theory, methodology and policy implications. The chapter ends with the limitations of the study and suggestions for future research.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 INTRODUCTION**

This chapter reviews past literatures on Islamic banking and Shari'ah audit. Firstly, the study discusses the principles of auditing and governance as an introduction to the concepts and practices of auditing and governance and how it has been practised all this while. Later on, the chapter explains the fundamental notion of auditing and governance within the Islamic banking industry. The chapter concludes by discussing the current practice of Shari'ah auditing.

#### **2.2 PRINCIPLES AND PRACTICES OF AUDITING AND GOVERNANCE**

Since the 19<sup>th</sup> century, auditing is performed by the professional accountants from audit firms who express their opinion in terms of the preparation of financial statements for companies, small entities, banks and other financial institutions. To help the auditors conduct their audit with honesty and integrity (Banaga, Ray, & Tomkins, 1994), the Financial Reporting Council, one of the authoritative bodies in the United Kingdom, has imposed standards and guidelines to be followed by these audit firms. The Financial Reporting Council (2007) stated the objective of an audit of financial statements in the following excerpt:

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (210).

With this objective of an audit, the auditors will collect and evaluate the evidences so that they can share their opinion and views on whether the financial statement of the specific institution has been prepared in accordance with the established criteria (International Shariah Research Academy (ISRA), 2011b). Consequently, auditors should always take into account the fundamental elements of auditing such as materiality, audit risk and reasonable assurance which will lead to some challenges in conducting the audit (Chong & Yee, 2007).

As auditing is about assurance, any opinion expressed based on the auditable areas will provide an outline on the governance system of the respective institution. For example, reasonable opinions expressed on the material aspects of financial statements show the efficiency and effectiveness of corporate management and internal business control. This exemplifies the importance of auditing and assurance, and how it is interrelated with corporate governance.

With respect to corporate governance, the study focuses on how a corporation and organisation are governed in its daily business operations. In this case, Macey and O'Hara (2003: 2) have acknowledged a corporation as a "complex set of explicit and implicit contracts" which can be understood as a form of contract between various claimants in the organisation to achieve certain objectives. This is in line with the American principle of corporate governance stated by Macey & O'Hara (2003: 2) that "it is an implicit terms of contract between shareholders and the firm i.e. the claimants to agree on the managers or director's duty to maximize shareholders' value in the firm."

To understand auditing in detail and how it relates to governance, the study reviews the theoretical aspects of auditing and how its practices have developed over time.