



THE MEASUREMENT OF EFFECTIVE INTERNAL *SHARĪ'AH* AUDIT FUNCTION IN ISLAMIC FINANCIAL INSTITUTIONS

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ABSTRACT

Assurance of *Sharī'ah* compliance through the *Sharī'ah* audit function is crucial for enhancing the integrity of Islamic Financial Institutions (IFIs). Effective *Sharī'ah* audit function during periodical assessment will ensure effective internal control system for *Sharī'ah* compliance in IFIs. This paper examines the measurement of effective internal *Sharī'ah* audit function in IFIs. It critically reviews the emerging literature on the importance of eight components for measuring effective internal *Sharī'ah* audit function. The components are *Sharī'ah* audit objective, *Sharī'ah* audit scope, *Sharī'ah* audit and governance, *Sharī'ah* audit charter, competency of internal *Sharī'ah* auditors, *Sharī'ah* audit process, reporting requirements and independence. These components are important for achieving effective internal control over *Sharī'ah* compliance. The study also performs a structured interview with Islamic financial experts to validate the measurement before it is further examined in future empirical studies. The main argument of this paper is that highly effective internal *Sharī'ah* audit function leads to inclusive opinion on reasonable assurance of *Sharī'ah* compliance. Assurance of *Sharī'ah* compliance should enhance stakeholder

confidence and satisfy the growing demand for IFIs accountability and sustainability.

JEL Classification: G30, M42, M48

Key words: *Sharī'ah* audit, *Sharī'ah* compliance, *Sharī'ah* governance, Islamic financial institutions

1. INTRODUCTION

In a competitive business environment, *Sharī'ah* compliance is perceived as one of the distinctive features differentiating Islamic Financial Institutions (IFIs) from their conventional counterparts. IFIs are mandated to operate based on *Sharī'ah* principles in all processes, systems and activities. *Sharī'ah* compliance is important in enhancing the viability of IFIs and to meet the growing demand for *Sharī'ah* compliant products (Abu Kasim, 2012). The extent of *Sharī'ah* compliance reflects the accountability and integrity of IFIs. Stakeholders expect IFIs to achieve the socio-economic targets outlined by the *Sharī'ah* (Dusuki, 2008). In the current global financial development, IFIs are also expected to establish responsible, inclusive and sustainable Islamic financial activities and operations (Bank Negara Malaysia, 2016).

Stringent regulations are imposed on the IFIs to gain significant trust from stakeholders (Alhabshi, 2016; Bank Negara Malaysia, 2016). Achieving full *Sharī'ah* compliance is challenging for IFIs but efforts to prevent *Sharī'ah* non-compliance activities should be welcomed (Ab Ghani and Abdul Rahman, 2015). The majority of IFIs offer Islamic financial products which comply with the *Sharī'ah* principles and guidelines established by the regulators. However, most IFIs normally may still fail due to bad governance (Askari, Iqbal and Mirakhor, 2009). The Islamic financial industry is facing *Sharī'ah* governance challenges; hence it is important that IFIs ensure effective *Sharī'ah* governance to enhance public trust and confidence (Abdul Rahman, 2011; Grassa, 2013).

Assurance of *Sharī'ah* compliance in Islamic financial activities through *Sharī'ah* audit practices is crucial in enhancing IFIs integrity. The main objective of this paper is to examine the measurement of effective internal *Sharī'ah* audit function in IFIs. The eight measurements of internal *Sharī'ah* audit effectiveness are *Sharī'ah* audit scope, *Sharī'ah* audit objective, *Sharī'ah* audit and governance, *Sharī'ah* audit charter, competency of internal *Sharī'ah* auditors, *Sharī'ah* audit process, reporting requirements and

independence. Thus, examining the measurement of effective internal Shari'ah audit function may assist the Islamic financial industry and the regulators in enhancing the present regulatory requirements such as the *Shari'ah* governance framework of the respective jurisdictions.

2. LITERATURE REVIEW

2.1 EFFECTIVENESS OF INTERNAL AUDIT

The International Institute of Internal Auditors (IIA) (2011) defined internal audit as:

An independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process (2).

From this definition, it can be argued that internal audit effectiveness is crucial in providing reasonable assurance that the governance and internal control system in organizations are well-performed that they are able to minimize and monitor potential risks (The International Institute of Internal Auditors (IIA), 2011). In this case, IIA defined effectiveness and efficiency as "the degree (including quality) to which established objectives are achieved" (The Institute of Internal Auditors, 2010: 2). Therefore, the study argued that effective and efficient internal audit means the ability of an internal audit function to achieve the objective of internal audit which is to provide assurance on the internal control system of an organization.

To achieve internal audit objectives, IIA has established the standard internal audit guideline called the International Professional Practices Framework (IPPF) as the statutory requirements for internal auditors in organizations to conduct effective internal audit (The International Institute of Internal Auditors (IIA), 2011). IPPF consists of two sections termed the Attribute Standards and Performance Standards. Attribute Standards outline "the attributes of organisations and individuals performing internal auditing" while the Performance Standards outline "the nature of internal auditing and provide quality criteria against which the performance of these

services can be measured” (The International Institute of Internal Auditors (IIA), 2011: 12).

IIA then extended the IPPF to issue a practice guide on measuring internal audit effectiveness and efficiency (The Institute of Internal Auditors, 2010). The practice guide stressed that the important element in implementing an effective internal audit is to firstly understand the definition of internal audit effectiveness and efficiency. Secondly, the practice guide underlined that measurement criteria or performance criteria specifically related to the institutions and its operations need to be established before examining internal audit effectiveness (The Institute of Internal Auditors, 2010). The effective performance measures are established by the Chief Audit Executive (CAE) who will assist in identifying the key internal and external stakeholders, develop the measurement of internal audit effectiveness and monitor and report the results. The measurement criteria cover the internal audit processes, internal auditors’ capabilities, management of the organization and supervision by the audit committee. Finally, the institution can then examine the extent of effective internal audit function, monitor the result of internal audit review and align the internal audit activities with the aim to achieve reasonable assurance on the internal control system (The Institute of Internal Auditors, 2010).

Previous empirical studies on internal auditing show the significance of conducting effective internal audit. Academic scholars argued on the factors contributing to the effectiveness of internal audit such as internal auditor competency (Albrecht et al., 1998; Alzeban and Gwilliam, 2014; Lenz and Hahn, 2015; Soh and Martinov-Bennie, 2011), characteristics of internal audit function (Alzeban and Gwilliam, 2014; Arena and Azzone, 2009; Soh and Martinov-Bennie, 2011), relationship between internal and external auditors (Alzeban and Gwilliam, 2014; Badara and Saidin, 2014), management support for internal audit function (Ahmad et al., 2009; Albrecht et al., 1998; Alzeban and Gwilliam, 2014; Mihret and Yismaw, 2007; Soh and Martinov-Bennie, 2011), independence of internal auditors (Alzeban and Gwilliam, 2014) and senior management expectation (Cohen and Sayag, 2010; Fadzil, Haron and Jantan, 2005; Mihret and Yismaw, 2007; Sarens and Beelde, 2006). Effectiveness of internal audit function is important to ensure that internal auditors provide a reliable internal audit report (Johl et al., 2013) and that organizational operations are performed in accordance

with the rules and guidelines to achieve objectives (The Institute of Internal Auditors, 2010).

In terms of measurement, Ziegenfuss (2000) has developed questionnaire that includes 84 criteria for internal audit effectiveness. The study categorized five top performance measures of internal audit effectiveness such as staff experience, audit committee responsibility, management expectations of internal auditing, auditor education levels and percentage of audit recommendations implemented (Ziegenfuss, 2000). However, only a few studies have validated the scale of internal audit effectiveness. Therefore, Cohen and Sayag (2010) employed these 84 criteria proposed by Ziegenfuss (2000) and conducted interviews with the top management in Israeli organizations. Following interview feedback, they removed certain items before presenting them to the internal audit experts comprising both academics and practitioners in the field. In the end, 37 items were finalized to be the measurement of internal audit effectiveness. Cohen and Sayag (2010) developed conceptual understanding of internal audit effectiveness by developing and validating the scale in terms of organizational (public or private), internal auditors' professional proficiency, quality of audit work, organizational independence, career advancement and top management support in the organization. The study argued that the quality of audit work, evaluations of auditees and added contributions of internal audit are the three dimensions encompassing the concept of internal audit effectiveness (Cohen and Sayag, 2010). Furthermore, top management support was found to be the crucial element in internal audit effectiveness. All other dimensions such as hiring proficient internal audit staff, developing career channels for internal audit staff and providing organizational independence for internal audit work result from decisions made by the top management (Cohen and Sayag, 2010).

On the other hand, the effectiveness of internal audit could be measured in terms of the internal audit quality. If internal quality is maintained, it will contribute to the appropriateness of procedures and operations of the auditee and thereby internal audit contributes to organizational effectiveness as a whole (Dittenhofer, 2001). Dittenhofer (2001) stressed that effective audit procedures should enable internal auditors to determine the character and quality of the auditee's control operations effectiveness. Mihret and Yismaw (2007) found that internal audit quality has strong influence on internal audit effectiveness. They argued that internal audit quality

was measured in terms of the expertise of internal audit staff, the scope of service, effective audit planning, fieldwork and control and effective auditor-auditee communication. Cohen and Sayag (2010) also agreed that higher quality of auditing work relates to greater internal audit effectiveness.

Based on the above discussion, the study argued that an institution needs a standard guideline to perform an effective and systematic approach of internal auditing.

2.2 EFFECTIVENESS OF INTERNAL SHARĪ'AH AUDIT IN ISLAMIC FINANCIAL INSTITUTIONS

Sharī'ah audit is closely related to the practice of internal auditing in terms of the operational and compliance audit to provide assurance of *Sharī'ah* compliance in Islamic financial activities and operations. *Sharī'ah* audit looks into both financial and *Sharī'ah* information of the IFIs. The internal *Sharī'ah* auditors do not perform the financial statement audit as it is performed by the external auditors but instead, internal *Sharī'ah* auditors evaluate the financial statements to see that these do not include any *Sharī'ah* non-compliance matters and non-recognized profits (Ab Ghani and Abdul Rahman, 2015).

Previous scholars argued on the definition of *Sharī'ah* audit which is the act of gathering and assessing the evidence to provide *opinion on the information gathered that the activities and operations* meet the *Sharī'ah* criteria (Abdul Rahman, 2008). Internal *Sharī'ah* auditors performed the *Sharī'ah* audit practices by looking into both financial and *Sharī'ah* information of IFIs. Abdul Rahman (2008) argued that IFIs are in need of *Sharī'ah* audit to uphold stakeholder confidence in *Sharī'ah* compliance of Islamic financial activities. In the context of the religious legitimacy of IFIs, scholars advocate *Sharī'ah* audit as a mode of *Sharī'ah* compliance assurance in IFI operations (Mohamed Sultan, 2009), ensure the right and proper conduct of *Sharī'ah* compliant activities (Kasim, Mohamad Ibrahim and Sulaiman, 2009), assess the procedures of each product to ensure *Sharī'ah* compliance (Shafii, Salleh and Shahwan, 2010) and check the soundness of internal control systems (Shafii and Salleh, 2010).

Recently, an initiative was made to develop the Exposure Draft of Internal *Sharī'ah* Audit Framework (ISAF) which is yet to be established by Bank Negara Malaysia as the regulator (International *Sharī'ah* Research Academy (ISRA), 2011). The Exposure Draft of ISAF outlined the specific guidelines related to

Shari'ah audit practices such as *Shari'ah* audit scope, *Shari'ah* audit objectives, *Shari'ah* audit and governance, *Shari'ah* audit charter, competency of internal *Shari'ah* auditors, *Shari'ah* audit process and reporting requirements. This Exposure Draft of ISAF provides a systematic and guided approach for the IFIs to implement effective *Shari'ah* audit with other *Shari'ah* governance processes such as *Shari'ah* risk management, *Shari'ah* review and *Shari'ah* research function (International *Shari'ah* Research Academy (ISRA), 2011).

The study argued that effective *Shari'ah* audit could adopt the above definition of effective internal audit provided by the Institute of Internal Auditors (IIA) (The Institute of Internal Auditors, 2010: 2). Therefore, effective *Shari'ah* audit can be defined as the degree to which *Shari'ah* audit function achieved its established objectives to ensure effective internal control system for *Shari'ah* compliance as outlined by the *Shari'ah* Governance Framework (SGF) established by Bank Negara Malaysia. Effective *Shari'ah* audit function could provide reasonable assurance that Islamic financial activities and operations are *Shari'ah* compliant.

A conceptual research was done to determine the factors contributing to the effectiveness of internal *Shari'ah* compliance function in the Malaysian Takaful industry (Mohamad Puad, 2014). In this conceptual study, Muhammad Puad (2014) also aimed at examining the role of the internal *Shari'ah* compliance functions to manage *Shari'ah* non-compliance risks in the Takaful industry and to investigate the current *Shari'ah* review and *Shari'ah* audit practices in the industry. The study proposed a few variables which could positively contribute to internal *Shari'ah* compliance function effectiveness such as training and development, effective internal control system and audit experience. The research hypothesized that higher level of training and development, increase in effectiveness of internal control systems and higher audit experiences would enhance effectiveness of the internal *Shari'ah* compliance function in the Takaful industry (Mohamad Puad, 2014). Abdul Rahman (2011) earlier advocated the immediate need for IFIs to implement effective internal *Shari'ah* audit function rather than establishing the external *Shari'ah* audit practices. It is easier for the internal *Shari'ah* audit function to understand the nature of the Islamic financial operations in their respective IFIs thus being able to provide reasonable assurance of effective internal control systems for *Shari'ah* compliance (Abdul Rahman, 2011).

Another empirical study examined the relationship between three factors such as independence, competency and work

performance with effective internal *Sharī'ah* audit of IFIs in Bahrain (Khalid, Haron and Masron, 2017). The research found that competency and work performance in terms of engagement planning, performing engagement and communicating results of internal *Sharī'ah* audit were positively related to internal *Sharī'ah* audit effectiveness but independence does not significantly influence effective internal *Sharī'ah* audit. The study argued that the insignificant relationship between independence and internal *Sharī'ah* audit effectiveness is caused by the independence criteria such as the insufficient contribution of senior management support, reporting level and unrestricted access to all departments and employees to add value to the internal *Sharī'ah* audit effectiveness (Khalid et al., 2017).

Given the importance of conducting effective internal *Sharī'ah* audit, the study argued that specific measurement or standard guideline needs to be developed to implement effective and systematic approach of *Sharī'ah* audit function in IFIs which is yet to be established by the regulators.

3. RESEARCH METHODOLOGY

The research adopts purposive sampling through judgement sampling based on pre-determined groups or criteria (Cooper and Schindler, 2013). Judgement sampling allows the study to choose the respondents who are representative and in the best position to provide their perspectives on the measurement of effective internal *Sharī'ah* audit function (Sekaran and Bougie, 2016). Hence, the study selected the respondents from the group of practitioners in Bank Negara Malaysia as the regulator, group of internal *Sharī'ah* auditors in IFIs and group of academicians. These three groups of respondents are representative and come from diverse background to provide comprehensive perspectives on the measurements of effective internal *Sharī'ah* audit function. The respondent from Bank Negara Malaysia was selected because the person is directly involved in monitoring the *Sharī'ah* Governance Framework (SGF) implementation including establishment of the *Sharī'ah* audit function in IFIs. Meanwhile, the study acknowledged that each IFI has established the *Sharī'ah* audit function within the internal audit division as required by the SGF. Therefore, the internal audit division should have one particular person among the internal *Sharī'ah* auditors who is accountable to coordinate and manage the *Sharī'ah* audit practices in IFIs. The respective internal *Sharī'ah*

auditor must be well-informed on the scope, objectives, system and the process of *Shari'ah* audit in their respective IFIs. The particular internal *Shari'ah* auditor should be able to provide constructive feedback on the measurement of effective internal *Shari'ah* audit function. Therefore, the study selected the respective internal *Shari'ah* auditor from the full-fledged Islamic banks, Islamic banking subsidiary, Islamic window in commercial bank, Islamic banking business in Development Financial Institutions (DFIs) and Takaful operators to obtain inclusive responses from all types of IFIs. Finally, the group of academicians with related accounting and Islamic finance expertise are also selected to provide scholarly perspectives on the suitability and authenticity of the components used to measure effective internal *Shari'ah* audit function in IFIs.

The study employs qualitative approach using structured interviews with the respondents. Structured interviews are appropriate because the instrument provides structured guideline for the respondents to provide their responses (Sekaran and Bougie, 2016). The structured framework is important so that respondents can provide their constructive feedback on the measurement of effective internal *Shari'ah* audit function. All respondents were then given a set of measurement criteria in a booklet during the interview. The measurement criteria include eight sections such as *Shari'ah* audit scope, *Shari'ah* audit objective, *Shari'ah* audit and governance, *Shari'ah* audit charter, competency of internal *Shari'ah* auditors, *Shari'ah* audit process, reporting requirements and independence.

This research aims at examining the measurement of effective internal *Shari'ah* audit function in IFIs. Since there is limited research conducted on the effectiveness of *Shari'ah* audit, the study adapts the relevant performance criteria used to evaluate the effectiveness of internal audit developed by previous scholars. The research also adopts the Exposure Draft of Internal *Shari'ah* Audit Framework (ISAF) (International *Shari'ah* Research Academy (ISRA), 2011) and the *Shari'ah* Governance Framework (SGF) (Bank Negara Malaysia, 2010) as a benchmark for developing the eight components to measure effective internal *Shari'ah* audit in IFIs.

The measurement of effective internal *Shari'ah* audit function needs to be validated by the expert respondents who are directly or indirectly involved in *Shari'ah* audit practices. Validation on the measurement is important because the *Shari'ah* audit framework is yet to be established by Bank Negara Malaysia as the regulator. Meanwhile, the Exposure Draft of Internal *Shari'ah* Audit

Framework (ISAF) established by the International *Sharī'ah* Research Academy (ISRA) (2011) is currently not practised as a standard guideline by the IFIs. Previous study has examined the current practices of *Sharī'ah* audit in IFIs using the Exposure Draft of ISAF and the measurements were agreed by the majority of Heads of *Sharī'ah* audit, internal *Sharī'ah* auditors, *Sharī'ah* executives and *Sharī'ah* Committee members (Ab Ghani and Abdul Rahman, 2015). The same measurement can be used to examine the effectiveness of internal *Sharī'ah* audit function in IFIs. The eight measurement components cover overall components to establish a systematic and disciplined approach of effective internal *Sharī'ah* audit function in IFIs (International *Shariah* Research Academy (ISRA), 2011).

In this respect, the component of *Sharī'ah* audit scope includes audit of financial statements, compliance audit on organizational structure, people, process and information technology application systems and review of adequacy of the *Sharī'ah* governance process as outlined by SGF (Bank Negara Malaysia, 2010). Meanwhile, the component of *Sharī'ah* audit objective includes the establishment of *Sharī'ah* compliant internal control system, complete standard operating procedures and reliability of reporting system in IFIs (International *Sharī'ah* Research Academy (ISRA), 2011). This is in line with the aim of *Sharī'ah* audit function to achieve an effective internal control system for *Sharī'ah* compliance (Bank Negara Malaysia, 2010). Besides that, the study adopts measurement criteria of *Sharī'ah* audit and governance which covers the establishment of *Sharī'ah* audit function within the internal audit division. The *Sharī'ah* audit and governance component also include the accountabilities and responsibilities of the Board of Directors who perform the ultimate oversight role on *Sharī'ah* governance framework and *Sharī'ah* compliance in Islamic financial operations (Bank Negara Malaysia, 2010). In addition, *Sharī'ah* audit charter is measured in terms of the deliberation of purpose, scope and responsibilities of *Sharī'ah* audit function within the internal audit division (International *Sharī'ah* Research Academy (ISRA), 2011).

The competency of internal *Sharī'ah* auditors includes adequate knowledge in *Sharī'ah* and Islamic financial contracts. The competency criteria also cover the ability to conduct appropriate *Sharī'ah* audit tests and assess the operations of the *Sharī'ah* governance framework apart from the proficiency to apply internal auditing standards and accounting principles (International *Shariah* Research Academy (ISRA), 2011). Later, measurement of effective

internal *Sharī'ah* audit function outlines the important components to conduct *Sharī'ah* audit process such as essential matters in the *Sharī'ah* audit plan, auditable areas for *Sharī'ah* compliance assessment and evaluation of effective *Sharī'ah* governance function in IFIs (International *Shariah* Research Academy (ISRA), 2011). The measurement of effective *Sharī'ah* audit function must also cover reporting requirements such as communication of *Sharī'ah* non-compliance findings to the Board Audit Committee and *Sharī'ah* Committee members, recommendation for rectifying *Sharī'ah* non-compliance and timeliness of *Sharī'ah* audit report (International *Sharī'ah* Research Academy (ISRA), 2011). Finally, the study measures the effectiveness of internal *Sharī'ah* audit function in terms of the independence of internal *Sharī'ah* auditors (The International Institute of Internal Auditors (IIA), 2011). The independence criteria include the impartial attitude of internal *Sharī'ah* auditors to be free from conflict of interest, unrestricted access to assess specific operations in IFIs and freedom from interference to establish the scope of *Sharī'ah* audit.

These measurements are important to implement a systematic approach of effective internal *Sharī'ah* audit function. Respondents will then provide their feedback in writing on the suitability of measurement criteria on internal *Sharī'ah* audit effectiveness. The study analyzed the descriptive data according to the key categories relevant to the purpose of this research (Merriam, 2009). In this respect, data analysis is performed based on the eight measurement components of effective internal *Sharī'ah* audit function and respective findings are discussed in the following section.

4. FINDINGS AND DISCUSSIONS

Overall, the study has selected ten respondents from the following groups; regulators, internal *Sharī'ah* auditors and academicians. These respondents have provided their positive responses to participate in the structured interviews. The respondents include one practitioner from Bank Negara Malaysia, five internal *Sharī'ah* auditors from different types of IFIs and four academicians. These respondents are representative of their respective institutions and possess relevant expertise in *Sharī'ah* audit and Islamic finance. The profile of each respondent is summarized in Table 1. The demographic profile shows that most respondents (60%) have more than 20 years' experience in *Sharī'ah* audit and Islamic finance. This includes one regulator, one internal *Sharī'ah* auditor and all four

academicians. Another 20% of the total respondents which are the Head of *Shari'ah* audit also have 10 to 15 years' experience in the related field. The profile shows that the study has selected the best respondents who will provide inclusive and prudent perspectives on the measurement of internal *Shari'ah* audit function in IFIs.

TABLE 1
Profile of Respondents

Respondent	Gender	No. of Years of Experience in Shariah Audit & Islamic finance	Designation	Institution
R1	Male	Over 20 years	Manager in Islamic banking and Takaful department	Regulator (Bank Negara Malaysia)
P1	Female	10 – 15 years	Internal Shariah auditor	Full-fledged Islamic bank
P2	Male	0 – 5 years	Internal Shariah auditor	Islamic subsidiary of local conventional bank
P3	Male	6 – 10 years	Internal Shariah auditor	Islamic window in commercial bank
P4	Male	10 – 15 years	Internal Shariah auditor	Takaful operator
P5	Female	Over 20 years	Internal Shariah auditor	Islamic banking business in Development financial institution
A1	Female	Over 20 years	Academician	Public University
A2	Female	Over 20 years	Academician	Public University
A3	Female	Over 20 years	Academician	Public University
A4	Female	Over 20 years	Academician	Public University

The findings from the structured interviews were then discussed in the following section according to the eight measurement components. The measurement of effective internal *Shari'ah* audit function includes *Shari'ah* audit scope, *Shari'ah* audit

objective, *Sharī'ah* audit and governance, *Sharī'ah* audit charter, competency of internal *Sharī'ah* auditors, *Sharī'ah* audit process, reporting requirements and independence.

4.1 *SHARĪ'AH* AUDIT SCOPE

Audit scope is an important aspect in measuring effective internal audit as it directs the conduct of internal audit to achieve the objectives of internal audit engagement which is to provide assurance of the internal control system in the organization (The International Institute of Internal Auditors (IIA), 2011). Previous study emphasized the internal audit scope to comply with the requirement established by the Standards for the Professional Practice of Internal Auditing (SPPIA) (Al-Twaijry, Brierly and Gwilliam, 2003). *Sharī'ah* audit scope as outlined by the SGF is an important measurement of effective internal *Sharī'ah* audit function (Bank Negara Malaysia, 2010). The scope of *Sharī'ah* audit function includes the *Sharī'ah* matters related to the financial statements in IFIs such as the recognition of income and expenses and zakat computation, effectiveness of *Sharī'ah* internal control system, reviewing the *Sharī'ah* non-compliance risks management function and any special *Sharī'ah* audit assignments requested by the Board or the *Sharī'ah* Committee (Abdul Rahman, 2011).

In this respect, the research found that the internal *Sharī'ah* auditors from the commercial bank and Development Financial Institution (P3 and P5) argued that there is always an issue with the *Sharī'ah* audit scope of financial statement when certain IFIs appoint external auditors to perform this specific scope. The respondents acknowledged that SGF allows IFIs to appoint external auditors to conduct *Sharī'ah* audit on the Islamic financial operations for the respective IFI (Bank Negara Malaysia, 2010). The case normally happens in the Islamic windows of commercial banks when the IFIs have limited expertise to perform *Sharī'ah* audit scope of financial statement. The respondents highlighted that it is challenging for IFIs to examine the effectiveness of internal audit function when *Sharī'ah* audit scope is conducted by the external auditors. External auditors normally deal with financial statement audit which is different from *Sharī'ah* audit scope on financial statement. *Sharī'ah* audit scope on financial statement aims at ensuring that the elements in financial statements such as recognition, distribution and purification of income and expenses including zakat computation are free from *Sharī'ah* non-compliance issues (Abdul Rahman, 2011; International

Sharī'ah Research Academy (ISRA), 2011). The study suggested that IFIs establish additional approach to examine the extent of effective internal *Sharī'ah* audit in terms of the *Sharī'ah* audit scope when it is outsourced to external auditors. IFIs must ensure that the external auditors establish a systematic approach to implement the *Sharī'ah* audit function similar to the one conducted by the internal *Sharī'ah* auditors within the IFIs. It is also important for the external auditors to check for any *Sharī'ah* non-compliance issues to achieve assurance of *Sharī'ah* compliance in financial statements.

With respect to the *Sharī'ah* audit scope of compliance audit on organizational structure, the regulator (R1) agreed that the function, reporting line and communication between Board of Directors, management and *Sharī'ah* Committee members shall be used to measure effective *Sharī'ah* audit function. This is because every organizational structure shall include various reporting lines to reflect the accountabilities and responsibilities of each key function to provide check and balance between the functions. Overall, all respondents agreed that effective *Sharī'ah* audit function can be measured through the *Sharī'ah* audit scope as required by the SGF.

Previous empirical study found that the actual scope of *Sharī'ah* audit is only limited to the financial statement audit especially in terms of the *Sharī'ah* compliance of Islamic banking products (Kasim, Mohamad Ibrahim and Sulaiman, 2009). Apart from the audit of financial statement, another research argued that IFIs should conduct their *Sharī'ah* audit program to include all aspects of IFI activities and operations such as compliance audit and internal controls of the organizational structures and review on *Sharī'ah* governance (Shafii et al., 2014; Yahya and Mahzan, 2012). Another empirical study stated that most full-fledged IFIs have established the *Sharī'ah* audit of financial statement. However, Islamic banking subsidiaries lack the practice on *Sharī'ah* audit of financial statement because the subsidiaries consider the scope as the responsibilities of the external auditors who normally performs the financial statement audit (Ab Ghani and Abdul Rahman, 2015). As a result, accounting transactions may include the *Sharī'ah* non-compliance matters and non-recognized profits. This may then lead to *Sharī'ah* non-compliance risk in Islamic financial operations and ineffective internal *Sharī'ah* audit function in IFIs.

4.2 *SHARĪ'AH* AUDIT OBJECTIVE

According to the International Professional Practices Framework (IPPF), the engagement objective of internal audit is to perform preliminary assessment of the risks relevant to the activity. Upon determining the engagement objectives, internal auditors need to take into account the significant errors and any non-compliance with the laws and regulations (The International Institute of Internal Auditors (IIA), 2011). The measurement of *Sharī'ah* audit objectives includes objective of internal control, clear reporting lines and standard operating procedures (SOPs) and information technology application system (International *Sharī'ah* Research Academy (ISRA), 2011).

The study found that all respondents agreed that the effectiveness of the internal *Sharī'ah* audit function can be measured in terms of the above components of *Sharī'ah* audit objectives. The internal *Sharī'ah* auditor from Development Financial Institution (P5) also suggested additional criteria of *Sharī'ah* audit objectives such as adequacy of the policies, manuals and guidelines and not only the SOPs which are important in measuring internal *Sharī'ah* audit effectiveness. One academician (A1), however, argued that the definition of adequate, effective and complete needs to be clarified when measuring the adequate and effective internal control system and the completeness of standard operating procedures (SOPs) as part of the *Sharī'ah* audit objectives.

These findings are consistent with Abdul Rahman (2011) who argued that *Sharī'ah* audit objectives should primarily aim to ensure that internal *Sharī'ah* auditors provide the assurance on *Sharī'ah* compliance in all activities and operations in IFIs. Based on the SGF, the objective of *Sharī'ah* audit function is to ensure the effectiveness of internal control system for *Sharī'ah* compliance and it is performed in good manner (Bank Negara Malaysia, 2010). In practice, all Islamic banks have established the *Sharī'ah* audit objectives including specifying clear internal control objectives, adequacy of standard operating procedures (SOPs), reliability of the reporting system and information technology applications system in the IFIs (Ab Ghani and Abdul Rahman, 2015).

4.3 *SHARĪ'AH* AUDIT AND GOVERNANCE

With respect to audit and governance, internal audit function can be effective if the function promotes appropriate ethical values within the organization, ensures effective organizational performance management and communicate information among various

organizational levels (The International Institute of Internal Auditors (IIA), 2011). The measurement of *Shari'ah* audit and governance structure includes establishing the *Shari'ah* audit function within the internal audit division, consult *Shari'ah* Committee members in the *Shari'ah* audit plan and report the *Shari'ah* audit findings to the Board Audit Committee (International *Shari'ah* Research Academy (ISRA), 2011). In practice, Ab Ghani and Abdul Rahman (2015) found that most Islamic banks have established appropriate structure of *Shari'ah* audit and governance.

The study found that all respondents agreed on the measurement of effective *Shari'ah* audit function through the implementation of *Shari'ah* audit and governance structure. Similarly, another internal *Shari'ah* auditor from commercial bank (P3) argued on the way to examine the effectiveness of *Shari'ah* audit function when IFIs appoint external auditors to perform *Shari'ah* audit. The internal *Shari'ah* auditor from Takaful operator (P4) argued that *Shari'ah* audit function will be more effective if *Shari'ah* audit and governance includes appointment of *Shari'ah* Committee member as part of the Board of Directors in addition to the Board Audit Committee. This is in line with the requirement outlined in the SGF stating that IFIs can appoint at least one (1) member of the *Shari'ah* Committee as member of the Board (Bank Negara Malaysia, 2010).

According to the SGF, *Shari'ah* audit function can be effective if the function is established independent from the management division and report must be given directly to the Board through the Board Audit Committee (Bank Negara Malaysia, 2010). Upon establishing a dedicated unit of the *Shari'ah* audit function, IFIs need to consider their operational capacity in terms of human resource and costs related to the establishment (Abdul Rahman, 2011).

4.4 SHARĪ'AH AUDIT CHARTER

According to the IPPF, “internal audit charter is a formal document that defines the internal audit activity’s purpose, authority and responsibility” (The International Institute of Internal Auditors (IIA), 2011: 15). Audit charter is important in performing effective internal audit as it articulates the nature of internal audit function, reporting relationship and clearly specifies the authorization of access to all relevant records and documents to be used by the internal auditors.

In the structured guideline given to the respondents, the study previously combined the measurement on the purpose of *Sharī'ah* audit and responsibilities of internal *Sharī'ah* auditors in the same section for the *Sharī'ah* audit charter. Based on the structured interview findings, the regulator (R1) suggested that it is better to separate the purpose, mission and scope in one section and the responsibilities in another section in the *Sharī'ah* audit charter for better measurement of the *Sharī'ah* audit effectiveness. The rationale is that the respondents can easily understand and specifically focus on the relevant components when providing the information on effective *Sharī'ah* audit function. The clarity between purpose of *Sharī'ah* audit and responsibilities of internal *Sharī'ah* auditors could be ascertained to obtain constructive responses on effective *Sharī'ah* audit function. Meanwhile, another academician (A3) suggested to include the accountability and clause of ethical standards as part of the *Sharī'ah* audit charter to measure effective *Sharī'ah* audit function.

The findings are consistent with previous conceptual study by Abdul Rahman (2011) who argued that the internal *Sharī'ah* audit charter should include issues regarding the nature, objectives, scope, responsibilities, authority and independence of internal *Sharī'ah* audit function. The *Sharī'ah* audit charter could help to ensure effective conduct of *Sharī'ah* audit function as it clearly specifies the planning, implementation and reporting of internal *Sharī'ah* audit. In practice, Ab Ghani and Abdul Rahman (2015) found that most Islamic banks have established the *Sharī'ah* audit charter as part of the *Sharī'ah* audit function. However, only 50% of Islamic banking subsidiaries included the nature of internal *Sharī'ah* audit in the *Sharī'ah* audit charter to account for the distinctive features of *Sharī'ah* audit function within the internal audit division (Ab Ghani and Abdul Rahman, 2015).

4.5 COMPETENCY OF INTERNAL *SHARĪ'AH* AUDITORS

With respect to the competency of internal auditors, IPPF outlined that it is important for the internal auditors to possess the knowledge, skills and other competencies to perform internal audit activities (The International Institute of Internal Auditors (IIA), 2011). Abdul Rahman (2011) argued that internal *Sharī'ah* auditors should be proficient in applying internal auditing standards, accounting principles, understanding management principles, applying appropriate *Sharī'ah* audit tests and possess the communication skills

in dealing with people. The International *Sharī'ah* Research Academy (ISRA) (2011) also outlined the same competencies criteria which are important to ensure effective conduct of *Sharī'ah* audit function in IFIs.

Based on the interview findings, all respondents agreed that the effectiveness of *Sharī'ah* audit function can be measured in terms the adequate competency of internal *Sharī'ah* auditors. The competency components include the adequate knowledge and skills to apply internal auditing standards, accounting principles and relevant *Sharī'ah* audit tests. However, the regulator (R1) suggested to include training on risk management and corporate governance as additional competency criteria of internal *Sharī'ah* auditors to measure effective *Sharī'ah* audit function. The rationale is that internal *Sharī'ah* audit shall be performed according to the risk-based audit approach which requires internal *Sharī'ah* auditors to be trained in the risk management areas as well. In addition, all academicians suggested further definition on the level of adequate knowledge of *Sharī'ah* for internal *Sharī'ah* auditors when measuring the effective *Sharī'ah* audit function.

The findings are consistent with previous empirical study that stated the importance of internal audit function to adopt the professional proficiency criteria based on the SPPIA to implement effective internal audit function (Al-Twajry, Brierly and Gwilliam, 2003). Before the SGF establishment, a few studies found that current auditors lack the *Sharī'ah* qualification which is important for performing *Sharī'ah* audit practices (Besar, Abd Sukor, Abdul Muthalib and Gunawa, 2009; Kasim, Mohamad Ibrahim and Sulaiman, 2009). After the establishment of SGF in 2010, Ab Ghani and Abdul Rahman (2015) found that nearly all Islamic banks have established the competency criteria of internal *Sharī'ah* auditors. However, it is still challenging to implement effective *Sharī'ah* audit because not many *Sharī'ah* auditors have both expertise in *Sharī'ah* and Islamic financial system.

4.6 SHARĪ'AH AUDIT PROCESS

According to the IPPF, internal audit process should be conducted in an effective manner to achieve the internal audit engagement objectives (The International Institute of Internal Auditors (IIA), 2011). Based on the SGF, the *Sharī'ah* audit process requires the internal *Sharī'ah* auditors to formulate an audit plan which includes understanding the business activities of IFI, developing a

comprehensive internal audit program, obtaining the relevant *Sharī'ah* sources and conducting the periodical *Sharī'ah* audit process (Bank Negara Malaysia, 2010). In addition, *Sharī'ah* audit process should be performed according to the established *Sharī'ah* criteria including the written opinions by the *Sharī'ah* Advisory Council (SAC), *Sharī'ah* parameters from Bank Negara Malaysia, written opinions from the *Sharī'ah* Committee members and product manuals of the IFIs (Abdul Rahman, 2011). To implement an effective *Sharī'ah* audit process, internal *Sharī'ah* auditors should have full access to the audit evidence in the IFIs and the auditable areas should include assessment on internal control system for *Sharī'ah* compliance, *Sharī'ah* non-compliance risks and audit of product information and reporting (International *Sharī'ah* Research Academy (ISRA), 2011).

The study found that the academicians (A3) suggested to include the *Sharī'ah* strategy, aqad execution, product structure development and claim risk for Takaful as part of the auditable areas to measure effective *Sharī'ah* audit function when implementing a well-planned process of *Sharī'ah* audit. The rationale behind this is that the additional auditable areas are important for effective function of *Sharī'ah* audit to provide comprehensive coverage on the high risk areas which may lead to more *Sharī'ah* non-compliance risks for the IFIs.

The findings are in line with previous empirical study which found that almost all Islamic banks have established the *Sharī'ah* audit process as required by the SGF (Ab Ghani and Abdul Rahman, 2015). The *Sharī'ah* audit process has included the formulation of audit plan and auditable areas on *Sharī'ah* compliance requirements, assess the adequacy of *Sharī'ah* compliance review, establish the risk-based audit process and formulate the audit opinion on the effectiveness of the *Sharī'ah* internal control system (Ab Ghani and Abdul Rahman, 2015).

4.7 REPORTING REQUIREMENTS

After conducting the audit process, internal auditors must communicate the internal audit findings to the relevant personnel. According to the IPPF, findings from the internal audit engagement should include the opinion of effective internal control system, recommendations and suggestions for any corrective actions. Internal audit reporting must be supported by reliable information and must be able to meet stakeholder expectations (The International Institute

of Internal Auditors (IIA), 2011). Meanwhile, SGF outlined that the *Shari'ah* audit process results should be reported to the Board Audit Committee and *Shari'ah* Committee members. Internal *Shari'ah* auditors also need to recommend the rectification measures for any *Shari'ah* non-compliance matters found throughout the *Shari'ah* audit process (Bank Negara Malaysia, 2010). Abdul Rahman (2011) also stressed that internal *Shari'ah* audit reports should be endorsed by the Board Audit Committee and include any findings of *Shari'ah* non-compliance, assessment on the degree of recurring non-compliance, timelines for rectification and opinion on effective internal control system for *Shari'ah* compliance.

Overall, all respondents agreed that *Shari'ah* audit function effectiveness can be measured through establishing the above reporting requirements including proper communication of *Shari'ah* audit findings to the Board Audit and *Shari'ah* Committee members. However, the regulator (R1) suggested to distinguish between reporting and disclosure of *Shari'ah* audit findings. The separation is essential to show clarity in implementing appropriate reporting process to achieve effective *Shari'ah* audit function. In addition, the internal *Shari'ah* auditor from Development Financial Institution (P5) argued that the study should explain further on the way to assess the degree of recurring *Shari'ah* non-compliance as part of the reporting requirements. Clear assessment is important to reduce the occurrence of the same *Shari'ah* non-compliance issues in the respective IFIs.

The findings are also consistent with previous research which argued that majority of respondents agreed that the *Shari'ah* audit findings should be reported to the Board Audit Committee (Ab Ghani and Abdul Rahman, 2015). Prior to that, internal *Shari'ah* auditors may discuss any uncertainties in the *Shari'ah* audit findings with the *Shari'ah* Committee members since the Board Audit Committee may not have the expertise in *Shari'ah* (Shafii et al., 2013).

4.8 INDEPENDENCE

According to the IPPF, it is important for the internal audit activities to be independent from any threats that could lead to biased results (The International Institute of Internal Auditors (IIA), 2011). Similar to the internal audit practices, internal *Shari'ah* auditors should also have the independent mental attitude to perform the *Shari'ah* audit practices (Abdul Rahman, 2011).

Overall, all respondents agreed that the *Shari'ah* audit function can be effective when *Shari'ah* audit activities are free from interference in determining the *Shari'ah* audit scope, performing *Shari'ah* audit work and communicating the *Shari'ah* audit findings. If independence is impaired, internal *Shari'ah* auditors must disclose the details of impairment to the appropriate parties in the IFIs.

Likewise, another study by Kasim et al. (2009) found significant gap between the preferred and real independence of internal *Shari'ah* auditors in IFIs with the mean variance of 1.99. It is argued that there is overdependence of the internal *Shari'ah* auditors on the *Shari'ah* secretariat to perform the *Shari'ah* audit given the lack of *Shari'ah* background among the auditors (Kasim et al., 2009). Although SGF requires the IFIs to establish the *Shari'ah* audit function within the internal audit division, another research argued that IFIs also need to have alternative plan if stakeholders demand the establishment of distinctive *Shari'ah* audit department in future (Shafii et al., 2013). With the establishment of effective structure of governance, Ab Ghani and Abdul Rahman (2015) argued that all Islamic banks have ensured independence of the internal audit division from management and *Shari'ah* department as well as its accountability to the Board through the Board Audit Committee. In addition, *Shari'ah* audit function can be effective if internal *Shari'ah* auditors remain independent in the eyes of the stakeholders (Ahmad and Al-Aidaros, 2015).

5. CONCLUSION

This paper has examined the measurement of effective internal *Shari'ah* audit function, namely *Shari'ah* audit scope, *Shari'ah* audit objective, *Shari'ah* audit and governance, *Shari'ah* audit charter, competency of internal *Shari'ah* auditors, *Shari'ah* audit process, reporting requirements and independence. These components are argued as important criteria in achieving the objective of effective internal control system for *Shari'ah* compliance in IFIs. The measurement should be empirically examined in future studies to obtain clear understanding on the extent of effective internal *Shari'ah* audit function across all types of IFIs. Future empirical studies on the extent of effective internal *Shari'ah* audit function may give a clear direction for the IFIs to re-orientate the present function of internal *Shari'ah* audit in their respective institutions. The need for effective internal *Shari'ah* audit also provides the urgency for the relevant regulators to establish strong and sound

guidelines and framework for the IFIs to properly implement *Sharī'ah* audit. Effective function of *Sharī'ah* audit is imperative in assisting the Islamic financial industry and the regulators to effectively monitor and enhance the integrity and accountability of the Islamic financial industry.

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