



EFFECTIVENESS OF INTERNAL *SHARĪ'AH* AUDIT FUNCTION IN MALAYSIAN ISLAMIC FINANCIAL INSTITUTIONS

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ABSTRACT

An effective internal *Sharī'ah* audit function in Islamic financial institutions (IFIs) is imperative to ensure better management of *Sharī'ah* non-compliance risks through more robust *Sharī'ah* audit practices. This study evaluates the extent of internal *Sharī'ah* audit function effectiveness in Malaysian IFIs. It adopts a quantitative research method using a survey questionnaire. The total population of 47 IFIs during the data collection period (year 2016) was observed as the unit of analysis and targeted sample. Survey questionnaires were distributed to the Heads of *Sharī'ah* audit who are the key representatives of the internal *Sharī'ah* audit function in IFIs in Malaysia. The findings indicate that the majority of IFIs have established an effective level of internal *Sharī'ah* audit function which constitutes a positive development in strengthening *Sharī'ah* governance in IFIs in Malaysia. The study also contributes to rigorous monitoring and attention by Bank Negara Malaysia as the regulator on the effectiveness of the internal *Sharī'ah* audit function performed by Takaful operators and *Islāmic* windows in commercial and investment banks. This further emphasizes the crucial need for a holistic *Sharī'ah* compliance culture in IFIs to enhance the internal *Sharī'ah* audit function and ultimately ensure the integrity and accountability of IFIs.

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1. INTRODUCTION

Over the last few decades, Islamic financial institutions (IFIs) in Malaysia have been in high demand by the stakeholders and heavily regulated by Bank Negara Malaysia (BNM). The issuance of the Shariah Governance Framework (SGF, 2010) and the Islamic Financial Services Act (IFSA, 2013) have revealed tremendous support and monitoring by BNM to uphold *Sharī'ah* compliance and ensure effective *Sharī'ah* governance implementation in the IFIs. After ten years, BNM has extended the *Sharī'ah* governance paradigm by issuing the Shariah Governance Policy Document (SGPD, 2019) which emphasized more on the importance of a *Sharī'ah* compliance risk culture to strengthen *Sharī'ah* governance practices in all IFIs in Malaysia. The internal *Sharī'ah* audit function is one of the significant mechanisms within the *Sharī'ah* governance structure to perform an independent assessment and provides objective assurance that IFI business operations are *Sharī'ah* compliant. An effective internal *Sharī'ah* audit function is crucial to achieve the *Sharī'ah* compliance objective. Effective functioning is associated with the degree to which a group of people or organizations achieve the desired objectives. Therefore, an effective internal *Sharī'ah* audit function is imperative for ensuring better management of the *Sharī'ah* non-compliance risks through more robust *Sharī'ah* audit practices.

Prevailing issues of *Sharī'ah* governance and *Sharī'ah* audit in IFIs were highlighted in which IFIs normally fail, not because of offering *Sharī'ah* non-compliant products and services but because of bad governance and the lack of risk management (Askari, Iqbal, and Mirakhor, 2011). Such issues could lead to *Sharī'ah* non-compliance risks which then affect IFI integrity. The importance of *Sharī'ah* compliance has raised the need for an effective internal *Sharī'ah* audit function to be established within the IFIs to provide objective assurance of *Sharī'ah* compliance (Abdul Rahman, 2011). In this respect, IFIs have higher accountability to ensure *Sharī'ah* compliance in their operations, reporting, business conduct, risk management and governance, and monitoring and oversight functions. Higher integrity and transparency must be shown by the IFIs to underscore that they have established an effective *Sharī'ah* governance mechanism through the internal *Sharī'ah* audit function to achieve objective assurance of *Sharī'ah* compliance (Abdul Rahman, 2011). Without an

effective internal *Sharī'ah* audit function, the integrity of IFIs will be questioned and stakeholder confidence will be undermined.

Within five years since the issuance of the SGF (2010) to 2015, empirical studies in *Sharī'ah* audit have largely focused on various levels of the *Sharī'ah* audit practices in *Islāmic* banks in Malaysia (Ab Ghani and Abdul Rahman, 2015; Shafii, Mohd Ali and Kasim, 2014; Shafii et al., 2013a; Shafii et al., 2013b; Yahya and Mahzan, 2012). The majority of *Islāmic* banks have implemented an acceptable level of *Sharī'ah* audit practices using either a modified internal audit framework to accommodate *Sharī'ah* compliance or a self-developed *Sharī'ah* audit framework (Ab Ghani and Abdul Rahman, 2015; Yahya and Mahzan, 2012). Empirical studies have emphasized that *Islāmic* banks still face issues in the *Sharī'ah* audit scope, lack of a *Sharī'ah* audit charter, and lack of internal *Sharī'ah* auditors with adequate knowledge in *Sharī'ah* (Ab Ghani and Abdul Rahman, 2015). These *Sharī'ah* audit issues are more critical in the *Islāmic* subsidiaries of conventional banks that operate both conventional and *Islāmic* financial services. It is argued that the majority of *Islāmic* banks have not established a dedicated *Sharī'ah* audit function within the internal audit division (Yussof, 2013; Yahya and Mahzan, 2012). Hence, an effective internal *Sharī'ah* audit function is questionable.

Despite these critical issues of *Sharī'ah* audit practices, no past empirical studies exist on the effectiveness of the internal *Sharī'ah* audit function in IFIs in Malaysia. This has raised concern about the extent to which IFIs have established better management of *Sharī'ah* non-compliance risks in IFI business operations and whether the internal *Sharī'ah* audit function is conducted by a competent internal *Sharī'ah* auditor in the IFIs. Having an effective internal *Sharī'ah* audit function is not just about establishing the *Sharī'ah* audit function within the IFI internal audit division. In a highly regulated *Islāmic* finance industry in Malaysia, all IFIs have a statutory duty to comply with the minimum requirements to establish the internal *Sharī'ah* audit function and other *Sharī'ah* compliance functions as required by SGF (2010) and IFSA (2013). The study noted that all IFIs in Malaysia are recently mandated to establish effective *Sharī'ah* governance practices in compliance with SGPD (2019). In that respect, BNM requires IFIs to enhance effective implementation of the internal *Sharī'ah* audit function and other control functions by establishing the *Sharī'ah* compliance risk culture at all levels. Establishing the internal *Sharī'ah* audit function is required for obtaining objective assurance of *Sharī'ah* compliance in IFI business

operations. If stakeholders do not know the extent of the internal *Sharī'ah* audit function effectiveness; this could indicate that one of the important functions of *Sharī'ah* compliance i.e., the internal *Sharī'ah* audit function has not been effectively fulfilled. Without a study on internal *Sharī'ah* audit function, the robustness of the *Sharī'ah* audit practices and *Sharī'ah* compliance could not be determined.

Hence, this study aims at evaluating the extent of the internal *Sharī'ah* audit function effectiveness in IFIs in Malaysia by adopting SGF (2010) as the benchmark. This study was conducted in 2016 before issuance of the Shariah Governance Policy Document (SGPD, 2019) as part of postgraduate research to evaluate the effectiveness of the internal *Sharī'ah* audit function. At the time of this study, SGF (2010) was still effective. The year 2016 is exactly five years since all IFIs in Malaysia are required by BNM to comply with the SGF (2010) requirements. It is also significant that in 2016, BNM has issued other guidelines such as the Financial Reporting for Islamic Banking Institutions (FRIBI, 2016) and the Financial Reporting for Takaful Operators (FRTO, 2015) to complement the SGF (2010). Therefore, the findings from this study could further facilitate effective implementation of the recent issuance of SGPD (2019) by BNM which emphasized more on the importance of a *Sharī'ah* compliance risk culture to strengthen the *Sharī'ah* governance practices in all IFIs in Malaysia.

This study is unique as it evaluates the extent to which IFIs have achieved effective internal *Sharī'ah* audit function through establishing eight components of *Sharī'ah* audit objectives. The eight components are: *Sharī'ah* audit objectives, *Sharī'ah* audit scope, *Sharī'ah* audit and governance, *Sharī'ah* audit charter, competence of internal *Sharī'ah* auditors, *Sharī'ah* audit process, reporting requirements, and independence. This study also provides an added value to enhance IFIs accountability in achieving objective assurance of *Sharī'ah* compliance besides highlighting BNM as the regulator on crucial improvements needed on current policies and monitoring across various types of IFIs in Malaysia.

Next section discusses the overview of IFIs as a whole and *Sharī'ah* auditing in IFIs in Malaysia. This is followed by review of the relevant literature on effectiveness of internal *Sharī'ah* audit. Section 3 explains the research methodology. The study then discusses the findings of this study in Section 4 and finally concludes the research in Section 5.

2. BACKGROUND OF THE STUDY

2.1 OVERVIEW OF ISLAMIC FINANCIAL INSTITUTIONS IN MALAYSIA

Over the years, IFIs in Malaysia have emerged to provide financial mechanisms in line with the *Sharī'ah* principles for the Muslim population in Malaysia. The establishment of Tabung Haji in 1969 provided the first solution for the Muslim population to save in an *Islāmic* savings institution for the purpose of pilgrimage. In 1983, Bank Islam Malaysia Berhad (BIMB) was established as the first IFI in Malaysia to offer *Islāmic* financial products and services. Hence, IFIs in Malaysia have developed to offer *Islāmic* financial mechanisms for the stakeholders to achieve the important objective of *Sharī'ah* compliance in *Islāmic* business operations. After almost five decades, immense development of IFIs in Malaysia can be observed within the local and global financial landscape to offer *Islāmic* financial products and services to the Muslim as well as the non-Muslim population. Bank Negara Malaysia (2020) has reported enormous growth of *Islāmic* banking assets at 34.2% against total assets of *Islāmic* banking and Takaful in 2020. The fundamental nature of IFIs, which were established based on the *Sharī'ah* principles, considerably increased stakeholder interest to participate in IFI business operations. The importance of *Sharī'ah* compliance is critical among the stakeholders who highly valued and benefited from the *Islāmic* financial products and services offered in IFIs. *Sharī'ah* compliance is of crucial importance to protect stakeholder interests in IFIs (Grais and Pellegrini, 2006).

The critical need to ensure *Sharī'ah* compliance in IFI business operations cannot be underestimated. This is because IFIs in Malaysia have a significant role to play within the *Islāmic* financial development of the nation. IFIs are mandated to operate based on the *Sharī'ah* principles not only in terms of offering *Islāmic* financial products and services but also in their whole operational structure. In a nutshell, IFIs are accountable to ensure that the substance of *Islāmic* financial operations adhere to *Sharī'ah* principles, not only in terms of its legal form. In a competitive business environment and dual financial system in Malaysia, *Sharī'ah* compliance is perceived to be of utmost importance to enhance the distinctive features of IFIs as compared to their conventional counterparts.

Given the above situation, there is a crucial need for the IFIs to establish an effective approach to ensure *Sharī'ah* compliance at all

levels of IFI business operations. In addition, stringent regulations and guidelines are imposed by BNM as the regulator. This is important to ensure that these various forms of IFIs operate based on the *Sharī'ah* principles to gain significant stakeholder trust and confidence.

2.2 *SHARĪ'AH* AUDITING IN ISLAMIC FINANCIAL INSTITUTIONS

In the context of IFIs, the *Sharī'ah* audit function is highly accountable in terms of conducting an independent assessment and providing objective assurance concerning an effective internal control system and to ensure that IFI business operations are *Sharī'ah* compliant. The SGF (2010) has outlined that the objective assurance provided by the internal *Sharī'ah* audit function in each IFI needs to be communicated to the Board through the Board Audit Committee and *Sharī'ah* Committee members. The opinion concerning objective assurance for *Sharī'ah* compliance is then reported in the Shariah Committee Report of each IFI (Bank Negara Malaysia, 2010). Hence, stakeholders will be informed of the extent and assurance of *Sharī'ah* compliance for the *Islāmic* financial operations through the annual report. In that respect, it is important for the IFIs to ensure that the internal *Sharī'ah* audit function is effective to ensure better management of *Sharī'ah* non-compliance risks.

For IFIs, the three major types of auditing must be performed within the required scope to achieve the respective objectives. IFIs need to appoint the external auditors to perform audit on financial statements. External audit is important to obtain the opinion that the financial statements have been prepared in accordance with the financial reporting standards (Bank Negara Malaysia, 2014). Meanwhile, IFIs are also required to perform the internal audit function aimed at ensuring internal control system effectiveness, financial and operating information reliability and integrity, asset safeguarding as well as fraud, error and irregularity detection (Bank Negara Malaysia, 2010a). In relation to *Sharī'ah* compliance, IFIs need to establish the *Sharī'ah* audit function within the internal audit division. The internal *Sharī'ah* audit function aims at conducting independent assessment and providing objective assurance on effectiveness of the internal control system and ensuring that the IFIs business operations are *Sharī'ah* compliant (Bank Negara Malaysia, 2010b). Although SGF (2010) requires IFIs to establish the *Sharī'ah* audit function within the internal audit division, the *Sharī'ah* audit scope is more toward the *Sharī'ah* compliance audit. The context of internal audit scope that needs to be conducted in the IFIs is much

wider to cover other aspects of risk management, internal control system and management function in alignment with the regulatory framework.

2.3 THE EFFECTIVENESS OF INTERNAL *SHARI'AH* AUDIT FUNCTION

In 2011, the International Institute of Internal Auditors issued the International Professional Practices Framework (IPPF) as the statutory requirements for the internal auditors in organizations to conduct an effective internal audit function (The International Institute of Internal Auditors (IIA), 2011). In the IPPF, 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 organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process.”

From this definition, it can be argued that an effective internal audit is crucial to provide objective assurance that the organizational governance and internal control system is well-performed and that the organization is able to minimize and monitor its potential risks (The International Institute of Internal Auditors (IIA), 2011). In this respect, effectiveness is defined as the extent to which the set objectives are achieved. Therefore, an effective internal audit function is associated with its ability to achieve the set objectives, such as to provide objective assurance concerning effectiveness of the internal control system, risk management, and governance within the organization (The Institute of Internal Auditors (IIA), 2010).

In the context of IFIs, this study argues that an effective internal *Shari'ah* audit function could resemble the definition of an effective internal audit function provided by the Institute of Internal Auditors (IIA) (2010) and the objective of the internal *Shari'ah* audit function as outlined by the SGF (2010). According to the SGF (2010), the *Shari'ah* audit function refers to,

“The periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance

in relation to the IFI's business operations, with the aim to ensure a sound and effective internal control system for *Sharī'ah* compliance.”

Based on this definition, it is highlighted that the internal *Sharī'ah* audit function completes an independent assessment to provide objective assurance of *Sharī'ah* compliance in relation to the IFI business operations and effective internal control system. Therefore, this study defines an effective internal *Sharī'ah* audit function as the extent to which the internal *Sharī'ah* audit function achieves its set objectives to ensure an effective internal control system for *Sharī'ah* compliance as outlined by the SGF (2010). Ultimately, an effective internal *Sharī'ah* audit function aims at providing objective assurance that the IFI's business operations are *Sharī'ah* compliant.

3. PREVIOUS EMPIRICAL STUDIES AND MEASUREMENT OF EFFECTIVE INTERNAL *SHARĪ'AH* AUDIT FUNCTION

Earlier empirical studies have developed the measurement of effective internal audit function which includes meaningful internal audit findings, professionalism of internal audit function, adherence to audit plan, feedback from the auditee, audit environment, internal auditor competency and quality of internal audit work (Cohen and Sayag, 2010; Ziegenfuss, 2000; Albrecht et al., 1998). The Institute of Internal Auditors (IIA) (2010) extended the IPPF to issue a practice guide on measuring the effective internal audit function. Internal audit function effectiveness can be measured in terms of the internal audit processes, internal auditor capability organization management and supervision from the Board Audit Committee (The Institute of Internal Auditors (IIA), 2010). Similarly, Savcuk (2007) argued that the internal audit function effectiveness could be measured in terms of competency of internal auditors, internal auditing strategy and achievement of internal audit objectives.

The study also reviews previous empirical studies in various organization on the antecedents of an effective internal audit function. The antecedents which have been found to influence the internal audit function effectiveness include internal auditor competence, internal audit function characteristics, relationship between internal and external auditors, independence of internal auditors, management support for internal audit function, internal control system, risk management as well as communication with the Audit Committee

(Lenz and Hahn, 2015; Alzeban and Gwilliam, 2014; Badara and Saidin, 2014; Karagiorgos, Drogalas and Giovanis, 2011; Soh and Martinov-Bennie, 2011; Ahmad et al., 2009; Arena and Azzone, 2009). Previous empirical studies found the impacts of effective internal audit function on several elements. These include impacts on the financial reporting quality, internal control system quality, organizational performance and good governance (Gras-Gil, Marin-Hernandez and Garcia-Perez de Lema, 2012; Al-Shetwi et al., 2011; Fadzil, Haron and Jantan, 2005; Eden and Moriah, 1996).

In the IFI context, previous conceptual studies of *Sharī'ah* audit have explored factors that could positively influence the internal *Sharī'ah* audit function effectiveness such as training and development, effective internal control system and audit experience (Mohamad Puad, 2014). The research hypothesized that a higher level of training and development, increase in internal control system effectiveness and higher audit experience could lead to increased internal *Sharī'ah* compliance function effectiveness in the Takaful industry. Another study proposed that the independence, competence, and role of the *Sharī'ah* Supervisory Board (SSB) are the factors that could influence internal *Sharī'ah* audit function (Khalid, Haron and Masron, 2018; Khalid et al., 2018; Khalid and Sarea, 2018). The factors such as top management support, *Sharī'ah* audit process and organizational independence are proposed as the determinants of an effective internal *Sharī'ah* audit function in IFIs (Zakaria et al., 2019). Another recent study has also suggested the external and internal factors contributing to the internal *Sharī'ah* audit function effectiveness in IBs (Algabry et al., 2020). The study also emphasized that the IBs must ensure requirements such as the objectivity, independence and competency of internal *Sharī'ah* auditors in establishing an effective internal *Sharī'ah* audit process (Algabry et al., 2020).

Previous empirical study has examined the relationship between three factors – independence, competence and work performance – and the effective internal *Sharī'ah* audit of IFIs in Bahrain (Khalid, Haron and Masron, 2017). Within these three characteristics, Khalid et al. (2017) found that competence and work performance in terms of engagement planning, performing engagement and communicating results of the internal *Sharī'ah* audit were positively related to effectiveness of the internal *Sharī'ah* audit function. Recent empirical study has argued that the internal *Sharī'ah* audit function effectiveness in IBs in Yemen depends on

establishment of the *Sharī'ah* audit charter, *Sharī'ah* audit plan and *Sharī'ah* audit manual (Algabry et al., 2021).

Given the importance of establishing an effective internal *Sharī'ah* audit function in IFIs in Malaysia, this study argues that a specific measurement needs to be developed to examine the internal *Sharī'ah* audit function effectiveness in IFIs. The *Sharī'ah* audit function in the IFIs has complied with the SGF (2010) to conduct an effective internal *Sharī'ah* audit function although BNM has yet to issue a specific internal *Sharī'ah* audit framework to be implemented by the IFIs. Previous study by Ab Ghani, Mohd Ariffin and Abdul Rahman (2019) has developed the measurement of an effective internal *Sharī'ah* audit function. It is highlighted that the internal *Sharī'ah* audit function effectiveness be measured using eight components: *Sharī'ah* audit objectives, *Sharī'ah* audit scope, *Sharī'ah* audit and governance, *Sharī'ah* audit charter, competence of internal *Sharī'ah* auditors, *Sharī'ah* audit process, reporting requirements and independence (Ab Ghani et al., 2019). The study argued that the internal *Sharī'ah* audit function is effective when it implements these eight components (Ab Ghani et al., 2019).

One of the important components to measure effectiveness of the internal *Sharī'ah* audit function is by implementing the *Sharī'ah* audit objectives (Ab Ghani et al., 2019). These objectives include establishing an effective internal control system, comprehensive SOPs, decisive reporting requirements and strong information technology application system (Abdul Rahman, 2011). This is in line with the objective of an effective internal *Sharī'ah* audit function, which is to achieve objective assurance concerning effectiveness of the internal control system over *Sharī'ah* compliance (Bank Negara Malaysia, 2010b). At this stage, it is argued that the majority of IBs in Malaysia are set in the right direction to achieve the *Sharī'ah* audit objectives (Ab Ghani and Abdul Rahman, 2015).

Second, the *Sharī'ah* audit scope is adopted to measure the internal *Sharī'ah* audit function effectiveness (Ab Ghani et al., 2019). The SGF (2010) highlighted that a comprehensive *Sharī'ah* audit scope should cover the *Sharī'ah* audit of financial statements, compliance audit of the organizational structure, people, operations and IT application system as well as review the adequacy of the *Sharī'ah* governance process. In this respect, IFIs are examined to determine if their internal *Sharī'ah* audit function is effective when establishing the *Sharī'ah* governance structure to ensure *Sharī'ah* compliance in the IFI business operations (Abdul Rahman, 2011). A few issues arise with regard to the *Sharī'ah* audit scope of the financial

statements and establishing an accounting information system in a few IBs (Ab Ghani and Abdul Rahman, 2015). To achieve an effective internal *Sharī'ah* audit function, IFIs should establish a comprehensive *Sharī'ah* audit scope to avoid operational risk and any *Sharī'ah* non-compliance information in the financial statements.

Third, the internal *Sharī'ah* audit function effectiveness is measured by execution of *Sharī'ah* audit and governance (Ab Ghani et al., 2019). This includes establishment of the *Sharī'ah* audit function as part of the internal audit division and clear independence from the management and *Sharī'ah* division (Abdul Rahman, 2011). The *Sharī'ah* audit and governance component also highlighted the accountability and responsibility of the Board of Directors and Board Audit Committee in terms of the *Sharī'ah* audit plan and findings (Ab Ghani and Abdul Rahman, 2015). The SGF (2010) also stressed the Board of Directors responsibility since it holds the ultimate oversight role on the *Sharī'ah* governance structure and *Sharī'ah* compliance functions in the IFIs.

Moreover, the *Sharī'ah* audit charter is adopted as the measurement of the internal *Sharī'ah* audit function effectiveness (Ab Ghani et al., 2019). The component includes organizing the purpose and mission of the *Sharī'ah* audit function and highlighting the responsibilities of the internal *Sharī'ah* auditors (Abdul Rahman, 2011). The internal *Sharī'ah* auditor responsibilities include planning, performing and reporting of the *Sharī'ah* audit to the Board of Directors through the Board Audit Committee and *Sharī'ah* Committee members. The *Sharī'ah* audit charter is important so that the internal *Sharī'ah* auditors will understand the nature, objectives, and scope to perform an effective internal *Sharī'ah* audit function (Ab Ghani and Abdul Rahman, 2015).

An effective internal *Sharī'ah* audit function could be achieved when IFIs establish the competence criteria to appoint proficient internal *Sharī'ah* auditors (Ab Ghani et al., 2019). The competence of the internal *Sharī'ah* auditors includes proficiency in accounting principles and internal auditing standards (Abdul Rahman, 2011). More important is for the internal *Sharī'ah* auditors to have adequate knowledge of *Sharī'ah* and *Islāmic* financial contracts and the ability to construct appropriate *Sharī'ah* audit tests (Bank Negara Malaysia, 2010b). They also must have an understanding of the IFI operations and *Sharī'ah* compliance functions to implement an effective internal *Sharī'ah* audit function (Ab Ghani and Abdul Rahman, 2015).

Furthermore, the internal *Sharī'ah* audit function effectiveness is measured in terms of implementing a systematic *Sharī'ah* audit process (Ab Ghani et al., 2019). To be effective, the SGF (2010) outlines that the *Sharī'ah* audit process should accommodate the assessment of an effective and *Sharī'ah* compliant internal control system. In this respect, the internal *Sharī'ah* auditors should understand the IFI's business operations, establish the inclusive *Sharī'ah* audit program to include the essential *Sharī'ah* audit areas, and obtain access to the relevant documents (Bank Negara Malaysia, 2010b). Abdul Rahman (2011) suggested that the internal *Sharī'ah* audit function should establish the comprehensive *Sharī'ah* audit plan using the risk-based *Sharī'ah* audit process, formulate critical areas to be audited and evaluate the *Sharī'ah* governance function effectiveness in IFIs. The internal *Sharī'ah* audit process also includes assessment of the *Sharī'ah* risk management process to ensure that the *Islāmic* financial operations are not exposed to any *Sharī'ah* non-compliance risks (Abdul Rahman, 2011).

IFIs also should establish the relevant reporting requirements to communicate the *Sharī'ah* audit findings to the Board through the Board Audit Committee and *Sharī'ah* Committee members (Bank Negara Malaysia, 2010b). Ab Ghani et al. (2019) noted that reporting of internal *Sharī'ah* audit findings is a crucial component to measure internal *Sharī'ah* audit function effectiveness in IFIs. An effective internal *Sharī'ah* audit function will communicate findings of the *Sharī'ah* non-compliance risks and recommend corrective actions to the relevant parties (Abdul Rahman, 2011). The internal *Sharī'ah* auditors also need to track the rectification progress, ensure timeliness of the *Sharī'ah* audit report and finally provide their opinion regarding the objective assurance related to the *Sharī'ah* matters and the internal control system effectiveness (Abdul Rahman, 2011). The *Sharī'ah* audit report includes the opinion related to the *Sharī'ah* compliance of the financial statements, organizational structure, people, process, information technology application system and the *Sharī'ah* governance process (Ab Ghani et al., 2019).

Lastly, the internal *Sharī'ah* audit function effectiveness is measured in terms of the internal *Sharī'ah* auditor independence in performing their audit function (Ab Ghani et al., 2019). Internal *Sharī'ah* auditors must be free from any threats to determine the *Sharī'ah* audit scope and assess any relevant information to perform the internal *Sharī'ah* audit work (Abdul Rahman, 2011). The internal *Sharī'ah* audit report should be communicated and endorsed by the Board Audit Committee as well as presented to the *Sharī'ah*

Committee members to ensure confidentiality and avoid any threats to independence (Abdul Rahman, 2011).

4. RESEARCH METHODOLOGY

The main objective of this study is to evaluate the extent of the internal *Sharī'ah* audit function effectiveness in IFIs in Malaysia. This study exclusively focuses on each IFI as the unit of analysis and aims at evaluating the internal *Sharī'ah* audit function effectiveness at the institutional level. Since the unit of analysis is IFI, one respective sample from each IFI i.e., the Head of *Sharī'ah* Audit is representative to provide the information concerning the extent of the internal *Sharī'ah* audit function effectiveness in their respective IFI. The Head of *Sharī'ah* Audit is accountable for ensuring an effective internal *Sharī'ah* audit function aimed at providing objective assurance of *Sharī'ah* compliance. This person must be well-informed of the scope, objectives, systematic guidelines, and process of the internal *Sharī'ah* audit implemented in their respective IFI. In addition, the respective person must be the one who understands the *Sharī'ah* governance structure and other *Sharī'ah* compliance functions in the IFIs.

The data collection was conducted in 2016 by adopting the SGF (2010) as the benchmark. The study argued that previous empirical studies within the years 2010 to 2015 in *Sharī'ah* audit largely focused on the *Sharī'ah* audit practices and therefore the extent of internal *Sharī'ah* audit function effectiveness in IFIs in Malaysia is inconclusive. In 2016, BNM has issued other guidelines such as the FRIBI (2016) and FRTO (2015) to complement the establishment of SGF (2010) in all IFIs in Malaysia. Hence, 2016 is considered the ideal year to examine the internal *Sharī'ah* audit function effectiveness in IFIs in Malaysia i.e., five years after the effective date for the IFIs to comply with the SGF (2010) issued by BNM.

Survey questionnaire was developed to include the eight components on the measurement of effective internal *Sharī'ah* audit function which has been validated by the experts to assess its substantive validity (Ab Ghani et al., 2019; Anderson and Gerbing, 1991). The components include the *Sharī'ah* audit objectives, *Sharī'ah* audit scope, *Sharī'ah* audit and governance, *Sharī'ah* audit charter, competence of internal *Sharī'ah* auditors, *Sharī'ah* audit process, reporting requirements and independence. Appendix 1 summarized the eight components and items to measure the extent of internal *Sharī'ah* audit function effectiveness in IFIs in Malaysia.

The survey questionnaire was distributed to the Head of Shariah Audit in 47 IFIs in Malaysia. The IFIs consist of 16 Islamic Banks (IBs), *Islāmic* windows in seven commercial banks and three investment banks and six *Islāmic* banking businesses in DFIs as well as 11 Takaful operators and four Retakaful operators. The survey questionnaires were distributed personally to the respondents at the relevant IFIs. The study allocated two months for the respondents to complete and return the survey questionnaire using the self-addressed envelope provided. The respondents were provided with the definition of an effective internal *Sharī'ah* audit function to facilitate a clear understanding of the components and constructs in the survey questionnaire. They were requested to provide the responses according to a 5-point Likert-scale (1 = Highly ineffective, 2 = Ineffective, 3 = Somewhat effective, 4 = Effective, 5 = Highly effective). A Likert scale is used to perform constructive analysis on the responses given by the respondents (Cooper and Schindler, 2014). These responses indicate the extent of the internal *Sharī'ah* audit function effectiveness in their respective IFIs when implementing the eight components of effective internal *Sharī'ah* audit functions.

The study analyzes the data collected from the survey questionnaires using SPSS (Pallant, 2016). Descriptive statistical analysis was performed to evaluate the extent of internal *Sharī'ah* audit function effectiveness in IFIs in Malaysia. The responses based on the 5-point Likert-scale were aggregated in terms of the total mean scores based on each component of an effective internal *Sharī'ah* audit function. The study evaluates the respective IFIs that have achieved a highly effective internal *Sharī'ah* audit function with a score of '5' to lowest level of highly ineffective internal *Sharī'ah* audit function, which were given a score of '1'. After conducting the data analysis, the descriptive ranking profile of an effective internal *Sharī'ah* audit function is reported for each IFI.

5. FINDINGS AND DISCUSSION

5.1 PROFILE OF RESPONDENTS

Out of the total survey questionnaires distributed to 47 IFIs, the study received 40 responses. Another seven IFIs could not participate in the survey due to confidentiality matters and a few respondents in those IFIs were not reachable. The survey questionnaires were collected after a series of follow-ups within six months of the data collection period. However, only completed survey questionnaires from 39 IFIs

were included in the data analysis. Another one survey questionnaire from a Retakaful Operator was excluded because of incomplete responses. Table 2 provides the overview of the response rate from the survey questionnaire that were collected for each type of IFI. Based on Table 2, the total usable response rate for the survey questionnaires is remarkable at 82.98% with more than 50% of usable responses from each type of IFI. Out of the 39 IFIs, it is noted that there are four full-fledged IBs, nine *Islāmic* subsidiaries of local conventional banks, six *Islāmic* windows in commercial banks, two *Islāmic* windows in investment banks, six *Islāmic* banking business in DFIs, 10 Takaful Operators and two Retakaful operators. The high response rate enables the study to achieve comprehensive and comparative analysis of the extent of an effective internal *Sharī'ah* audit function in the respective IFIs in Malaysia.

TABLE 2
Overview of Response Rate

Type of Islamic Financial Institutions	Code	Distributed	Received	Usable Responses	Usable Response Rate (%)
Islamic Banks	IB	16	13	13	81.25%
Commercial Banks (<i>Islāmic</i> window)	IWCB	7	6	6	85.71%
Development Financial Institutions (<i>Islāmic</i> banking business)	DFI	6	6	6	100.00%
Investment Banks (<i>Islāmic</i> window)	IWIB	3	2	2	66.67%
Takaful Operators	TO	11	10	10	90.91%
Retakaful Operators	RTO	4	3	2	50.00%
Total		47	40	39	82.98%

5.2 EXTENT OF EFFECTIVE INTERNAL *SHARĪ'AH* AUDIT FUNCTION IN IFIS IN MALAYSIA

The study reports the analysis and discussion on the extent of the internal *Sharī'ah* audit function effectiveness in each IFI in Malaysia. To evaluate the extent of effectiveness, IFIs are assessed as to whether they have implemented the components of an effective internal *Sharī'ah* audit function in terms of the *Sharī'ah* audit objectives, *Sharī'ah* audit scope, *Sharī'ah* audit and governance, *Sharī'ah* audit charter, competence of internal *Sharī'ah* auditors, *Sharī'ah* audit process, reporting requirements and independence as discussed in the previous section (Ab Ghani et al., 2019; Abdul Rahman, 2011). Table 3 presents the ranking profile for the internal *Sharī'ah* audit function effectiveness for each IFI in Malaysia based on the total mean scores. The ranking analysis highlights the best practices for an effective internal *Sharī'ah* function across various types of IFIs as the unit of analysis in this study and could suggest further improvements that can be implemented by other IFIs and regulators.

Overall, the study found an effective level of internal *Sharī'ah* audit function in IFIs in Malaysia with total mean scores of 4.123 as reported in Table 3. It is noted that the effective level of the internal *Sharī'ah* audit function is achieved when implementing the eight components mentioned earlier. The mean score of more than 4.000 is shown for all components of an effective internal *Sharī'ah* audit function.

TABLE 3
 Ranking Profile of Effective Internal *Shari'ah* Audit Function in Each IFI

Islamic Financial Institutions	Components of Effective Internal <i>Shari'ah</i> Audit Function								Total Mean Score	Ranking	Range	Total IFIs
	<i>Shari'ah</i> Audit Objective	<i>Shari'ah</i> Audit Scope	<i>Shari'ah</i> Audit & Governance	<i>Shari'ah</i> Audit Charter	Competence of Internal Auditors	<i>Shari'ah</i> Audit Process	Reporting Requirements	Independence				
IB6	5.000	5.000	5.000	5.000	5.000	5.000	5.000	5.000	5.000	1	Highly Effective (Effective)	1
IB12	5.000	5.000	5.000	5.000	4.920	5.000	5.000	5.000	4.990	2		20
IB14	5.000	4.960	5.000	4.700	4.540	5.000	5.000	5.000	4.900	3		
TO3	4.430	4.710	5.000	5.000	4.850	5.000	5.000	5.000	4.870	4		
IB8	5.000	4.250	5.000	5.000	5.000	5.000	5.000	5.000	4.820	5		
TO7	4.860	4.880	4.500	5.000	4.620	4.960	4.730	4.400	4.810	6		
DFI3	4.290	4.630	4.830	5.000	5.000	4.800	4.910	5.000	4.790	7		
IWIB3	4.000	5.000	5.000	5.000	3.920	4.840	5.000	5.000	4.750	8		
IWCB3	4.570	4.640	4.830	4.900	4.310	4.670	5.000	4.800	4.680	9		
TO4	4.290	3.710	5.000	5.000	5.000	4.360	5.000	5.000	4.490	10		
IB15	4.290	4.670	4.500	4.500	4.380	4.240	4.180	3.800	4.380	11		

Table 3 (continued)

Islamic Financial Institutions	Components of Effective Internal <i>Shari'ah</i> Audit Function								Total Mean Score	Ranking	Range	Total IFIs
	<i>Shari'ah</i> Audit Objective	<i>Shari'ah</i> Audit Scope	<i>Shari'ah</i> Audit & Governance	<i>Shari'ah</i> Audit Charter	Competence of Internal Auditors	<i>Shari'ah</i> Audit Process	Reporting Requirements	Independence				
IWCB6	4.430	4.080	4.670	4.400	4.150	4.240	4.180	4.600	4.260	12		
TO9	3.710	3.860	4.670	4.400	4.230	4.320	4.550	4.800	4.240	13		
IB4	4.290	3.950	4.670	4.300	4.000	4.120	4.640	3.800	4.180	14		
DFI5	4.000	4.080	4.830	4.300	3.850	4.000	4.640	4.600	4.180	14		
IWCB5	3.570	4.000	5.000	4.800	4.080	4.080	4.450	3.800	4.180	14		
TO5	4.290	4.250	3.500	4.300	4.000	4.200	3.910	4.400	4.140	15		
TO1	3.710	3.880	4.670	4.600	3.920	3.920	4.270	4.600	4.080	16		
IB7	3.860	4.330	4.000	4.000	4.000	3.960	4.000	4.000	4.060	17		
IWCB7	4.140	4.040	3.330	4.000	4.460	4.000	4.090	3.400	4.020	18		
IWCB1	4.000	4.000	4.000	4.000	4.000	4.000	4.000	4.000	4.000	19		
DFI6	4.000	3.960	4.000	3.900	4.000	3.880	4.000	4.000	3.950	20	3.000-3.999	16
IWIB1	4.140	3.920	3.330	3.800	3.920	4.200	4.090	3.400	3.950	20	(Somewhat Effective)	
IB9	4.000	4.000	4.000	5.000	3.620	3.760	4.000	4.000	3.940	21		
IWCB4	4.000	4.000	4.000	4.000	4.000	3.840	4.000	3.800	3.940	21		

Table 3 (continued)

Islamic Financial Institutions	Components of Effective Internal <i>Shari'ah</i> Audit Function								Total Mean Score	Ranking	Range	Total IFIs
	<i>Shari'ah</i> Audit Objective	<i>Shari'ah</i> Audit Scope	<i>Shari'ah</i> Audit & Governance	<i>Shari'ah</i> Audit Charter	Competence of Internal Auditors	<i>Shari'ah</i> Audit Process	Reporting Requirements	Independence				
DFI1	4.000	3.630	4.000	4.000	4.000	4.000	4.000	4.000	3.910	22		
TO8	3.860	3.670	4.000	4.000	3.920	4.000	4.000	4.000	3.900	23		
DFI4	3.570	3.750	4.500	4.200	3.770	3.760	3.820	4.800	3.890	24		
IB1	4.000	3.670	4.330	3.900	3.920	3.920	3.820	4.000	3.880	25		
TO11	4.000	3.880	4.830	4.200	3.150	3.240	4.730	4.800	3.860	26		
TO2	3.430	3.830	4.500	3.600	4.150	3.480	4.000	4.400	3.820	27		
RTO1	3.570	4.330	3.670	3.800	3.230	3.680	3.910	4.000	3.820	27		
DFI2	3.710	3.760	4.000	0.000	3.850	3.600	3.820	4.000	3.760	28		
IB13	3.570	3.630	4.170	3.900	3.540	3.840	3.730	3.800	3.740	29		
TO10	4.000	3.290	4.000	3.000	3.690	3.880	4.000	4.000	3.660	30		
IB2	3.430	3.330	3.830	3.500	3.620	3.720	3.910	4.000	3.610	31		
IB11	3.570	3.740	4.000	3.200	3.690	3.460	3.450	3.400	3.570	32		
RTO3	3.290	3.170	2.170	3.000	3.000	2.760	2.730	3.400	2.940	33	2.000-2.999	2
IB16	3.710	2.670	2.500	3.100	3.690	2.640	2.360	2.000	2.830	34	(Ineffective)	

Table 3 (continued)

Islamic Financial Institutions	Components of Effective Internal <i>Shari'ah</i> Audit Function								Total Mean Score	Ranking	Range	Total IFIs
	<i>Shari'ah</i> Audit Objective	<i>Shari'ah</i> Audit Scope	<i>Shari'ah</i> Audit & Governance	<i>Shari'ah</i> Audit Charter	Competence of Internal Auditors	<i>Shari'ah</i> Audit Process	Reporting Requirements	Independence				
Total Mean Scores	4.066	4.054	4.278	4.245	4.077	4.086	4.228	4.226	4.123			39
Mean Score Ranking by Component	7	8	1	2	6	5	3	4				

Based on the findings in Table 3, *Sharī'ah* audit and governance is the highest component to contribute to the effective level of the internal *Sharī'ah* audit function. This is shown by a total mean score of 4.278. The result reflects that the majority of IFIs have established an effective internal *Sharī'ah* audit function as part of the internal audit division. The IFIs could either establish a dedicated *Sharī'ah* audit function or the *Sharī'ah* audit work related to the IFI business operations is embedded within the normal internal audit practices in the Group Internal Audit Division (Yahya, Mahzan and Abu Hasan, 2018; Yussof, 2013). With this level of effective *Sharī'ah* audit and governance, previous study argued that IFIs have ensured an acceptable level of governance, accountability and independence of internal *Sharī'ah* auditors in performing an effective internal *Sharī'ah* audit function (Abdul Rahman, 2011).

However, Table 3 reports the lowest total mean score of 4.054 for *Sharī'ah* audit scope in the majority of IFIs. The finding indicates the different levels of practice in the *Sharī'ah* audit scope related to the item such as audit of financial statements among various types of IFIs. Although SGF (2010) has outlined the *Sharī'ah* audit scope, each IFI has the right to determine the *Sharī'ah* audit scope based on the size and capacity of its IFI business operations. Hence, it is possible that smaller IFIs might outsource some components of the *Sharī'ah* audit scope, such as audit of financial statements to external auditors. The Heads of *Sharī'ah* audit in smaller IFIs have not rated the effective level of *Sharī'ah* audit scope related to financial statement auditing, leading to a lower level of effective *Sharī'ah* audit scope.

In analyzing the ranking profile for each IFI, Table 3 indicates that IB6 which is a full-fledged IB is the top scorer achieving a perfect total mean score of 5.000. This shows that IB6 has established a highly effective internal *Sharī'ah* audit function. The study found that IB6 has achieved a highly effective score for all components of the effective internal *Sharī'ah* audit function. This is attributed to the highest commitment shown by IB6 in reinforcing effective *Sharī'ah* governance that contributes to an outstanding level of effective internal *Sharī'ah* audit function. Before issuance of SGF (2010), previous studies emphasized that full-fledged IBs had established their own *Sharī'ah* governance structure including the internal *Sharī'ah* audit section within the internal audit department (Besar et al., 2009). Although there was no mandatory requirement to establish the *Sharī'ah* audit function before 2010, the *Sharī'ah* audit and review function had already been conducted in the full-fledged IB to ensure *Sharī'ah* compliance in its *Islāmic* financial operations (Shafii and

Salleh, 2010; Besar et al., 2009). This reflects that the *Sharī'ah* compliance culture is being placed within IB6 as the full-fledged IB to enhance its accountability and integrity as a pioneer IB. The understanding of its role as a full-fledged IB and establishment of a *Sharī'ah* compliance culture are important to differentiate IB6 from other IFIs in Malaysia (Hassan and Christopher, 2005; Chapra and Ahmad, 2002).

The second and fourth ranking are occupied by IB12 as the *Islāmic* subsidiary of local conventional bank and TO3 as the Takaful operator which are incorporated under the same Group with total mean scores of 4.990 and 4.870, respectively. The findings indicate that the effective results in IB12 and TO3 are contributed by the highly effective scores for almost all components of an effective internal *Sharī'ah* audit function. The reason could be due to incorporation of IB12 and TO3 under the same Group which leads both IFIs to achieve the same vision of establishing an effective internal *Sharī'ah* audit function. In addition, the stringent requirements emphasized by IFSA (2013) also impacted on the entire IBs, TOs and the Group in terms of its accountability to establish an effective internal *Sharī'ah* audit function and *Sharī'ah* governance structure (Abdul Rahman, Hassan and Mohamad, 2017). Being part of the Group enables IB12 and TO3 to have the best examples from the existing and well-developed governance structure and internal control systems within the Group's financial institutions and subsidiaries. With the issuance of SGF (2010) and the statutory requirement in IFSA (2013), there is a possibility that the Group has reinforced a strong *Sharī'ah* governance structure for IB12 and TO3 as their *Islāmic* subsidiaries. With high support from the Group, IB12 and TO3 are able to strategize their current *Sharī'ah* governance structure and achieve an effective internal *Sharī'ah* audit function. Hence, stakeholder confidence concerning *Sharī'ah* compliance in the *Islāmic* financial operations in IB12 and TO3 could be enhanced. However, it is acknowledged that TO3 has the lowest mean score of 4.430 and 4.710 in the component of *Sharī'ah* audit objective and *Sharī'ah* audit scope, respectively. Although both scores are still within the effective range, it could reflect the current requirement on the *Sharī'ah* audit scope in SGF (2010) is mainly focused on IB operations which might be insufficient for Takaful operators.

Similarly, IB14 and IB8 as the two (2) *Islāmic* subsidiaries of local conventional banks also occupied the third and fifth ranking with total mean scores of 4.900 and 4.820, respectively. The effective result in IB14 and IB8 are also contributed by the highly effective scores for

almost all components of effective internal *Shari'ah* audit function indicated in Table 3. As they are prominent *Islāmic* subsidiaries of conventional banks and Takaful operators, the findings reflect sufficient resources could be contributing to the effective internal *Shari'ah* audit function in IB12, IB14, TO3 and IB8. With sufficient resources, these *Islāmic* subsidiaries of conventional banks and Takaful operators could prioritize their assets and human resource capacity in establishing an effective internal *Shari'ah* audit function (Wan Abdullah, Percy and Stewart, 2015). The larger total assets could enable these IFIs to bear the higher cost of employing competent internal *Shari'ah* auditors. Sufficient resources could potentially reflect adequate staff being appointed to perform an effective internal *Shari'ah* audit function within the Group Internal Audit Division (Alzeban and Gwilliam, 2014; Yussof, 2013; Ahmad et al., 2009).

However, TO8 and TO10 as the full-fledged Takaful operators have occupied the 23rd and 30th ranking with a satisfactory (somewhat effective) level of internal *Shari'ah* audit function. This is given by the total mean score of 3.900 in TO8 and 3.660 in TO10. Based on the findings in Table 3, the satisfactory (somewhat effective) result is affected by the lowest mean score of 3.670 and 3.290 for the component of *Shari'ah* audit scope implemented by TO8 and TO10, respectively. Being a full-fledged Takaful operator does not necessarily reflect that TO8 and TO10 can establish a highly effective internal *Shari'ah* audit function. As discussed previously, TO3 also achieved lowest scores in the components of *Shari'ah* audit objective and *Shari'ah* audit scope. Based on the survey findings, one of the respondents highlighted that the *Shari'ah* audit scope in SGF (2010) should have included an assessment of the core activities of Takaful operators. This includes *Shari'ah* compliance audit on Takaful contribution from participants, product development, underwriting, and surplus distribution. Similarly, the reason could be the lack of regulation and requirement in SGF (2010) which mainly focused on IB operations. A previous study pointed out that the current regulation in SGF (2010) is lacking in terms of the *Shari'ah* audit scope to include all possible *Shari'ah* non-compliance risks specifically related to Takaful operations (Mohamad Puad and Shafii, 2019). Hence, TO10 and other TOs achieving the satisfactory (somewhat effective) result may have contributed less priority to effort to achieve an effective internal *Shari'ah* audit function for almost all components indicated in Table 3. This study argues that BNM as the regulator should provide more attention through rigorous monitoring on

effectiveness of the internal *Sharī'ah* audit function in the Takaful operators.

This study also found that two (2) full-fledged foreign IBs – IB2 and IB11 – are also among the lowest scorers for an effective internal *Sharī'ah* audit function. The total mean scores of 3.610 in IB2 and 3.570 for IB11 reported in Table 3 show the satisfactory (somewhat effective) level of effective internal *Sharī'ah* audit function. The satisfactory (somewhat effective) result is influenced by the lowest score for the component of *Sharī'ah* audit scope in IB2 and the lowest score for the *Sharī'ah* audit charter component in IB11 with mean scores of 3.330 and 3.200, respectively. Based on the survey findings, the *Sharī'ah* compliance audit on organizational structure and *Islāmic* financial operations in IB2 is lacking. Meanwhile, IB11 has not established an effective purpose, mission, or responsibilities of internal *Sharī'ah* auditors to achieve an effective internal *Sharī'ah* audit function.

The reason for the lower result in IB2 and IB11 is likely attributable to the different home country requirements on top of complying with the SGF (2010) as required by BNM in Malaysia. Previous studies debated the different regulations and jurisdictions of *Sharī'ah* governance in GCC countries issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) that need to be complied with by the foreign full-fledged IBs, such as IB2 and IB11 (Shafii, Zainal Abidin and Salleh, 2015; Alkhamees, 2013; Yussof, 2013; Hasan, 2011;). Apart from that, the foreign full-fledged IBs have also adopted the self-regulated approach of a *Sharī'ah* governance model, which is different from the SGF (2010) (Yussof, 2013). For instance, the *Sharī'ah* compliance review and audit on products and services in IB2 and IB11 are performed on a voluntary basis (Alkhamees, 2013) and conducted by the *Sharī'ah* Supervisory Board (SSB) (Shafii et al., 2015). With the additional requirement by the headquarters in their country of origin, IB2 and IB11 might contribute less priority to establish an effective *Sharī'ah* audit scope and *Sharī'ah* audit charter as required by the SGF (2010).

Besides that, RTO3 occupies the second lowest ranking with a total mean score of 2.940. This reflects an ineffective level of internal *Sharī'ah* audit function. The finding shows that the mean score of 2.170 in the component of *Sharī'ah* audit and governance has contributed to the ineffective result in RTO3. This could potentially reflect a lower capacity and insufficient resources for the internal *Sharī'ah* audit function within the Group Internal Audit in the Group Reinsurance Company. It could be attributed to the smaller size and

total asset of Retakaful operations within the RTO3 branch in Malaysia. Previous studies stated that the size of the internal audit function influences the public sector effective internal audit function (Alzeban and Gwilliam, 2014; Ahmad et al., 2009). In the context of IFIs, lower total assets could provide a challenge for RTO3 to cover the higher operational costs to establish an effective internal *Sharī'ah* audit function (Abdul Rahman et al., 2017). This includes establishing a dedicated internal *Sharī'ah* audit function and employing competent internal *Sharī'ah* auditors to perform effective internal *Sharī'ah* audit function. In addition, the size of RTO3 is quite small to cover certain *Sharī'ah* non-compliance risks when operating Retakaful operations. As a result, RTO3 might not have sufficient resources or capacity to implement an effective internal *Sharī'ah* audit function.

Finally, IB16 is the lowest scorer in the ranking for an effective internal *Sharī'ah* audit function among all the IFIs. IB16 has achieved an ineffective level of internal *Sharī'ah* audit function with a total mean score of 2.830. The study found that the component of independence in IB16 is ineffective with a total mean score of 2.000. The detailed findings indicate that the internal *Sharī'ah* audit function in IB16 has implemented an ineffective independence component for the items such as ensuring that the *Sharī'ah* audit activity must be free from interference in determining the *Sharī'ah* audit scope and performing the *Sharī'ah* audit work. As an *Islāmic* subsidiary of a foreign conventional bank, the internal *Sharī'ah* audit function for IB16 may be performed within the Group Internal Audit in the Group Conventional Bank (Yahya et al., 2018; Yussof, 2013). This means that the internal *Sharī'ah* audit function is only conducted by the internal auditors when they need to deal with *Islāmic* banking operations in IB16. Without an independent internal *Sharī'ah* audit function, there could be some interference in determining the *Sharī'ah* audit scope within the Group Internal Audit Division and reporting of the internal *Sharī'ah* audit findings (Shafii et al., 2013a). The size of the *Islāmic* banking operations in IB16 as an *Islāmic* subsidiary may be quite small compared to its main conventional business operations in the Group Conventional Bank. Hence, the ineffective result may be due to a lack of commitment or priority to implement independence component and enhance effectiveness of the internal *Sharī'ah* audit function in IB16.

In general, the study noted that the majority of IFIs have an effective internal *Sharī'ah* audit function. This is indicated by the fact that slightly more than half of the IFIs (21 out of 39) achieved a mean score of more than 4.000, as shown in Table 3. The study focuses

discussion on the top five rankings in the profile because these five IFIs have achieved a highly effective score for almost all components of an effective internal *Sharī'ah* audit function. Other IFIs within the top 20 ranking reflect an acceptable level of effective internal *Sharī'ah* audit function in IFIs in Malaysia with various effective mean scores in the respective components as shown in Table 3. Overall, the acceptable level of effective internal *Sharī'ah* audit function is mainly contributed by the full-fledged IBs and highly diversified size and types of IFIs. It is indicative that being a full-fledged IFI could contribute toward establishing higher level of effective internal *Sharī'ah* audit function. Therefore, IFIs could follow the best *Sharī'ah* compliance practices implemented in the full-fledged IBs to achieve higher level of effective internal *Sharī'ah* audit function.

6. CONCLUSION

This study emphasized the importance of establishing effective internal *Sharī'ah* audit function in all IFIs as part of the BNM requirement through the SGF (2010). The internal *Sharī'ah* audit function effectiveness is examined based on the extent to which the IFIs have established better management of the *Sharī'ah* non-compliance risks. The full-fledged IBs are found to be the most effective in establishing an internal *Sharī'ah* audit function; this indicates that they are able to establish robust *Sharī'ah* audit practices and *Sharī'ah* compliance structure. Sufficient resources enable larger IFIs to prioritize their human resource capacity in employing competent internal *Sharī'ah* auditors to implement effective internal *Sharī'ah* audit function. The study also emphasizes the importance of establishing effective *Sharī'ah* audit objectives, *Sharī'ah* audit scope, *Sharī'ah* audit and governance, competence of internal *Sharī'ah* auditors, *Sharī'ah* audit process, and reporting requirements as well as to ensure independence in achieving the internal *Sharī'ah* audit function effectiveness in IFIs in Malaysia.

Takaful operators and *Islāmic* windows in commercial and investment banks, however, are found to be less effective in establishing the internal *Sharī'ah* audit function. The current *Islāmic* finance industry regulations mainly focus on IB operations. The Takaful industry is seen as being less developed compared to IBs. Hence, full-fledged Takaful operators could not inherit the best practices and existing structure from the Group of companies and need to depend solely on the BNM regulatory framework. Smaller business

operations could also contribute towards less priority in establishing effective internal *Sharī'ah* audit function in *Islāmic* windows.

Several limitations have been acknowledged such as the adoption of SGF (2010) to develop the measurement and research instrument since the data collection was conducted in 2016 before the issuance of SGPD (2019). This study is also part of a postgraduate research which started from 2015. As explained earlier, 2016 is considered the ideal year to examine effectiveness of the internal *Sharī'ah* audit function in IFIs in Malaysia (i.e., five years after the effective date for the IFIs to comply with the SGF (2010) issued by BNM). Although SGF (2010) has been superseded by BNM, the findings provide the contribution in facilitating effective internal *Sharī'ah* audit function in IFIs in Malaysia as required by SGPD (2019). This study also notes the response bias in adopting survey questionnaires as the research instrument. Hence, several measures were adopted to mitigate the limitation such as performing expert validation test to ensure face validity and suitability of the questions to measure extent of internal *Sharī'ah* audit function.

This study contributes to enhancement of the *Islāmic* finance industry in Malaysia, especially for developing an effective internal *Sharī'ah* audit function in IFIs. The IFIs could increase their resources by hiring and providing adequate professional training to develop competent internal *Sharī'ah* auditors to conduct effective internal *Sharī'ah* audit function. The management function could also be enhanced in relation to their responsibility toward establishing the *Sharī'ah* compliance culture and effective support to the internal *Sharī'ah* audit function. The findings also suggest the need for more BNM regulatory attention to provide rigorous monitoring on the internal *Sharī'ah* audit function in Takaful operators and *Islāmic* windows in commercial and investment banks. Rigorous monitoring on the specific *Sharī'ah* governance scope and process related to Takaful and *Islāmic* windows' business operations are crucial in facilitating establishment of an effective internal *Sharī'ah* audit function. Hence, this could enhance Takaful industry development and increase sustainability of the *Islāmic* windows in commercial and investment banks in line with other IFIs in Malaysia.

Review on the recent issuance of the SGPD (2019) shows more improvement to the previous requirement in SGF (2010) specifically to strengthen the oversight accountabilities of the Board, *Sharī'ah* Committee members and the key functions within the *Sharī'ah* governance structure in the IFIs. The requirement to establish a strong *Sharī'ah* compliance risk culture within the IFIs will ensure a

more active role from the Board, *Shari'ah* Committee members and senior management in relation to *Shari'ah* compliance matters (Bank Negara Malaysia, 2019). This study has contributed to strengthening the effective implementation of *Shari'ah* governance and reinforcing closer integration of *Shari'ah* in IFI business operations as required by SGPD (2019).

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APPENDIX 1

Components and Items of Effective Internal *Shari'ah* Audit Function

Components	Items to be implemented to indicate Effective Internal <i>Shari'ah</i> Audit Function
<i>Shari'ah</i> Audit Objectives	Clearly specified internal control objectives; Adequate internal control system; Effective implementation of internal control system; Completeness of the standard operation procedures (SOPs), policies, manuals and guidelines; Timeliness of the reporting system and requirements; Reliability of the reporting system and requirements; Reliability of the information technology applications;

APPENDIX 1 (continued)

Components	Items to be implemented to indicate Effective Internal <i>Sharī'ah</i> Audit Function
Sharī'ah Audit Scope	<p>Audit of financial statement to look into any <i>Sharī'ah</i> non-compliance issues (Sub-items: Deposits; Investment accounts; Financing; Investment asset; Recognition of income and expenses; Distribution of income or profit; Purification of income (if any); <i>Zakāt</i> computation)</p> <p>Compliance audit on organizational structure (Sub-items: <i>Sharī'ah</i> governance structure; <i>Sharī'ah</i> review function; <i>Sharī'ah</i> risk management function; <i>Sharī'ah</i> research function; Roles and functions of the Board; Roles & functions of the management; Roles and functions of the <i>Sharī'ah</i> Committee members; Formal reporting channel on <i>Sharī'ah</i> matters.)</p>
	<p>Compliance audit on people including competent staff with integrity to manage and execute IFI's activities and operations.</p> <p>Compliance audit on IFI's processes and operations (Sub-items: Compliance of activities and operations with the <i>Sharī'ah</i> principles and Fiqh Muamalat; Products approval by the <i>Sharī'ah</i> Committee members; <i>Sharī'ah</i> screening process; Assessment of adequate number of qualified staff; Assurance of <i>Sharī'ah</i> compliance operation for <i>Islāmic</i> financial products.)</p> <p>Compliance audit on information technology application system to cater to the needs for <i>Sharī'ah</i> compliant activities.</p> <p>Review on adequacy of <i>Sharī'ah</i> governance process.</p>
	<p>Establishment of <i>Sharī'ah</i> audit function as part of the internal audit division; Independent from management and <i>Sharī'ah</i> department; Accountable directly to the Board through the Board Audit Committee;</p> <p>Determination of the deliverables of <i>Sharī'ah</i> audit by the Board Audit Committee; Endorsement and review of the <i>Sharī'ah</i> audit plan by the Board Audit Committee; Submission of the <i>Sharī'ah</i> audit findings for deliberation of Board Audit Committee.</p>

APPENDIX 1 (*continued*)

Components	Items to be implemented to indicate Effective Internal <i>Sharī'ah</i> Audit Function
<i>Sharī'ah</i> Audit Charter	<p>Purpose, mission & scope (Sub-items: Nature of internal <i>Sharī'ah</i> audit; Internal <i>Sharī'ah</i> audit objectives; Scope of internal <i>Sharī'ah</i> audit work; Accountability of internal <i>Sharī'ah</i> audit; Clause of ethical standards.)</p> <p>Responsibilities of the internal <i>Sharī'ah</i> auditors (Sub-items: Planning, examining and reporting of the internal <i>Sharī'ah</i> audit; Planning of annual <i>Sharī'ah</i> audit activities; Communication of <i>Sharī'ah</i> audit activities to the <i>Sharī'ah</i> Committee members; Direct access to the management and <i>Sharī'ah</i> Committee members; No limitation of scope and restriction to perform <i>Sharī'ah</i> audit.)</p>
Competence of Internal <i>Sharī'ah</i> Auditors	<p>Proficiency in applying internal auditing standards and procedures;</p> <p>Proficiency in accounting principles and techniques;</p> <p>Understanding of management principles;</p> <p>Skills in dealing with people;</p> <p>Skills in oral and written communications;</p> <p>Adequate knowledge in Usul Fiqh relevant to Fiqh Muamalat;</p> <p>Adequate knowledge about sources of <i>Sharī'ah</i>;</p> <p>Adequate knowledge about principles of <i>Islāmic</i> financial contracts;</p> <p>Adequate knowledge about <i>Islāmic</i> financial contracts relevant to IFIs in Malaysia;</p> <p>Ability to construct appropriate audit tests in line with the <i>Sharī'ah</i> audit objectives;</p> <p>Adequate knowledge and understanding of the functions of IFI;</p> <p>Adequate knowledge on risk management;</p> <p>Adequate knowledge on corporate governance.</p>
<i>Sharī'ah</i> Audit Process	<p>Essential matters for effective <i>Sharī'ah</i> audit process (Sub-items: Formulation of audit plan; Assessment of the adequacy of <i>Sharī'ah</i> compliance review; Establishment and implementation of the risk-based audit process and procedures; Evaluation of effective implementation of internal <i>Sharī'ah</i> compliance requirements; Audit documentation in the form of audit programme, audit objectives, internal <i>Sharī'ah</i> control system and relevant sources; Formulation of audit opinion.)</p>

APPENDIX 1 (continued)

Components	Items to be implemented to indicate Effective Internal <i>Sharī'ah</i> Audit Function
<i>Sharī'ah</i> Audit Process	<p>Auditable areas to be covered (Sub-items: Understanding of the management awareness, commitment and compliance control procedures for adherence to the <i>Sharī'ah</i>; Risk assessment of the <i>Sharī'ah</i> non-compliance risks to assess the risk profile of IFIs activities and operations; Assessment of the adequacy of internal control system for <i>Sharī'ah</i> compliance; Audit of contracts and agreements; Audit of product manuals and standard operating procedures; Audit of product structure and development; Audit of information and reports (e.g. circulars, minutes of meeting, operating and financial reports and policies etc.); Audit of profit computation and distribution; Audit of <i>Zakāt</i> computation and distribution; Audit of penalty computation and manner of distribution; Audit of promotion and marketing materials.)</p> <p>Evaluation of adequacy and effectiveness of controls encompassing IFI's governance, operations and information systems (Sub-items: Reliability and integrity of financial and operational information; Effectiveness and efficiency of activities and operations; Safeguarding of assets; Compliance with laws, regulations and contracts)</p> <p>Assessment on the adequacy of the <i>Sharī'ah</i> risk management processes (Sub-items: <i>Sharī'ah</i> non-compliance risk arising from activities and operations; Level of <i>Sharī'ah</i> non-compliance risks determined by the management and Board; Risk mitigation activities designed to reduce risk at acceptable levels; On-going monitoring activities to assess the effectiveness of controls to manage the risk)</p>
	<p>Report the findings of <i>Sharī'ah</i> non-compliance risks and controls (if any);</p> <p>Assess the degree of recurring of non-compliance and its systematic effect on the IFI as a whole;</p> <p>Recommend corrective actions, improvements and rectifications necessary to relevant person;</p> <p>Suggest timelines for any rectifications of <i>Sharī'ah</i> non-compliance matter to be completed;</p> <p>Track and monitor the progress of rectifications from past recommendations of previous report;</p>
Reporting Requirements	

Appendix 1 (*Continued*)

Components	Items to be implemented to indicate Effective Internal <i>Sharī'ah</i> Audit Function
Reporting Requirements	<p>Communicate the results of <i>Sharī'ah</i> audit assessment to the Board Audit Committee and <i>Sharī'ah</i> Committee; Provide report on regular interval or on ad-hoc basis; Report approved by the Board Audit Committee; Ensure timeliness of <i>Sharī'ah</i> audit report; Report includes opinion on whether the internal control system for <i>Sharī'ah</i> compliance is effective; Report includes opinion on the <i>Sharī'ah</i> audit of financial statements, compliance on organizational structure, people, process, information technology application system and <i>Sharī'ah</i> governance process.</p>
Independence	<p><i>Sharī'ah</i> audit activity must be free from interference in determining the scope of <i>Sharī'ah</i> audit, performing work and communicating results; Internal <i>Sharī'ah</i> auditors possess impartial, unbiased attitude and avoid any conflict of interest; Internal <i>Sharī'ah</i> auditors must not be refrained from assessing specific operations for which they were previously responsible; Provide consulting services relating to <i>Sharī'ah</i> compliance operations for which they had previous responsibilities; If independence is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties.</p>