

Competency and effectiveness of internal *Shariah* audit in Islamic financial institutions

Effectiveness
of internal
Shariah audit

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Azam Abdelhakeem Khalid

*Faculty of Management and Economics, Universiti Pendidikan Sultan Idris,
Perak, Malaysia*

Hasnah Haron

*Faculty Industrial Management, Universiti Malaysia Pahang,
Kuantan, Malaysia, and*

Tajul Ariffin Masron

School of Management, Universiti Sains Malaysia, Penang, Malaysia

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Abstract

Purpose – The purpose of this paper is to propose the conceptual relationship between competency and effectiveness of internal *Shariah* auditors in Islamic financial institutions (IFIs).

Design/methodology/approach – Normative and theorizing based on the main sources of Islam, mainly *Maqasid al-Shariah* theory, has been utilized in this research.

Findings – This study demonstrated how *Maqasid al-Shariah* or higher objectives of Islamic law have gradually captured the attention of increasing numbers of modern Muslim scholars for solving contemporary issues.

Originality/value – This study uniquely captured *Maqasid al-Shariah* for the competency of internal *Shariah* auditor.

Keywords Skills, Knowledge, Training, Effectiveness, Competency, *Shariah* auditor

Paper type Conceptual paper

Introduction

Shariah audit function is performed by internal auditors having adequate *Shariah*-related knowledge and skills. It is handled by the internal audit departments of Islamic financial institutions (IFIs) and they should be able to demonstrate that there is no threat to their independence such that an outsider would not doubt the auditor's objectivity (Arens, 2008; Messier and Boh, 2004). Their essential goal is to ensure a sound and effective internal control system which is in compliance with the *Shariah* rules and principles (Yaacob, 2012). *Shariah* audit is an examination of the extent of IFI compliance, in all their activities, with the *Shariah*. This examination includes contracts, agreements, policies, products, transactions, memorandum and articles of associations, financial statements, reports (especially internal audit and central banks inspection), circulars, etc. (AAOIFI, 2010). *Shariah* auditing is of key importance as there is a growing awareness among IFIs that every such institution should contribute toward achieving the objectives of Islamic law, the *Maqasid al-Shariah* (Shahul and Yaya, 2005). The objective of a *Shariah* audit is to ensure that the activities carried out by an IFI do not contravene the *Shariah*.



The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has issued a number of governance standards and guidelines. One of the objectives of AAOIFI is to develop accounting and auditing thoughts relevant to IFIs. The AAOIFI carried out these objectives in accordance with the precepts of Islamic *Shariah* that represent a comprehensive system for all aspects of life and in conformity with the environment in which IFIs are developed (AAOIFI, 2010). According to AAOIFI (2010), the internal *Shariah* audit shall be carried out by an independent division/department or part of the internal audit department, depending on the size of the IFI. It shall be established within an IFI to examine and evaluate the extent of compliance with Islamic *Shariah* rules and principles, Fatwas, guidelines and instructions issued by the IFIs *Shariah* supervisory board (SSB), hereafter referred to as *Shariah* rules and principles. The primary objective of the internal *Shariah* audit is to ensure that an IFI discharges its responsibilities in relation to the implementation of the *Shariah* rules and principles as determined by the IFI's SSB. The internal *Shariah* audit is an integral part of *Shariah* governance of an IFI and operates under the policies established by the IFI. It shall have a statement of purpose, authority and responsibility (charter). The charter is prepared by the management and has to be consistent with the Islamic *Shariah* rules and principles. The charter needs to be approved by the SSB of the IFI and issued by the board of directors; and this charter shall be regularly reviewed (AAOIFI, 2010). An internal *Shariah* audit involves first planning of each review assignment and the documentation. Then it includes collection, analysis and interpretation of all matters related to the review's objectives and scope of work, including the examination documentation, analytical review, inquiries, discussions with management and observations to support their review results (Roszaini, 2010).

Previous studies revealed that the requirement for effective internal *Shariah* auditors is yet to be developed even though there is a need for it. Thus, this paper argues for an effectiveness framework for internal *Shariah* auditors in IFIs. There is indeed an urgent need to draft the effectiveness requirements including knowledge, professional care, skills, training and audit experience to ensure an effective internal *Shariah* audit in IFIs. Generally, knowledge refers to the basic understanding of a person, be it information or a certain process. In the context of *Shariah* auditing, the acquired knowledge can be general or specific knowledge (Ali *et al.*, 2015). General knowledge can be obtained by having university education. Meanwhile, specific knowledge to develop competent internal *Shariah* auditor is in the form of training such as AAOIFI. Therefore, auditing, ethics, fraud awareness, internal auditing standards and technical knowledge of the industry are considered as the five main areas of knowledge with regard to the competencies to perform work of internal auditors (Ali *et al.*, 2015).

Skills refer to the ability of an individual to apply knowledge and know-how to complete task and solving problems. For the internal *Shariah* auditors of IFIs, being able to apply their *Shariah* knowledge in the form of knowledge in products and services would allow them to understand the transactions that occurred in IFIs, thus allowing them to be able to detect non-*Shariah* compliance products or activities. However, this can only be done by those with internal *Shariah* audit skills.

The concept, effectiveness, has received an increasing attention by the literature in recent times. Internal auditors assist the management in ensuring a proper internal control system in place and that the operations of the company are carried out efficiently, economically and effectively. An effective internal *Shariah* audit helps develop the work of an Islamic bank because the financial reports reflect the quality of the internal *Shariah* audit department. The internal *Shariah* audit department is very important to an IFI. Internal *Shariah* audit is regarded as the key element in the application of accounting systems which in turn helps

evaluate the work of the department. The internal *Shariah* audit is considered as the backbone of business accounting as it records all business transactions related to the sector. It is about advising entities how to achieve their objectives by managing risks and improving internal control. Even though internal *Shariah* audit is useful for all types of IFIs, much of it is required by the public sector where its objectives are usually broad, complex and not easy to measure.

Therefore, maintaining an effective internal *Shariah* audit is very critical to the management. AAOIFI emphasizes on the internal *Shariah* audit independence, competence and performance of audit work in enhancing its effectiveness. The IFI requires the head of internal *Shariah* audit to report directly to SSB. Moreover, an internal *Shariah* audit function should be performed impartially, professionally and with due professional care to support internal *Shariah* audit independence and competence. The internal *Shariah* audit's work is influenced by SSB as it supports the work of internal *Shariah* audit and ensures that it maintains its quality in carrying out its task (Al-Mahmoud, 2007). However, there is no previous study in IFIs in terms of the effectiveness of internal *Shariah* audit. Internal *Shariah* audits are needed because the current internal audits have no intention of providing reasonable assurance that their Islamic banking activities are *Shariah* compliant.

The rapid growth of IFIs results in the industry to not being able to produce enough experts to support this growth (Iqbal and Molyneux, 2005). Many professionals have not gained much of the required experience to enable them to competently advise or manage IFI transactions. An internal *Shariah* auditor experience is still relatively scarce in some IFIs. This phenomenon will affect the effectiveness of internal *Shariah* auditors in IFIs. To address this issue among the trained professional auditors of IFIs, the AAOIFI has offered training leading to Certified *Shariah* Advisor and Auditor (CSAA) and Certified Islamic Professional Accountant (CIPA) qualifications. In fact, this is a positive initiative, but no prerequisites are required to enroll in these courses. The targeted candidates are those who are currently involved with *Shariah* compliance and review of banking and finance, professional and executives who are currently involved in accounting, auditing and finance and professional and executives with interests in the fields of *Shariah*, accounting, auditing or finance (Othman *et al.*, 2015).

In addition, the qualifications do not cover the complete AAOIFI standards. Hence, this leads to the question of how many internal *Shariah* auditors in IFIs are truly qualified. The *Shariah* department is always under-resourced, and it is most regrettable if the management keeps on treating it as low priority (Rehman, 2012) when the role is so fundamental for the existence of the IFI. In recognition of these challenges, the International Financial Services Board (IFSB) (2006) states that the audit committee of institutions offering Islamic financial services should make best efforts in ensuring that the external auditors are capable of accommodating ex-post *Shariah* compliance reviews (relying, where appropriate, on work carried out by internal auditors or *Shariah* reviewers), within their terms of reference. In cases where this is possible, the audit committee and the internal auditor or *Shariah* reviewer shall work closely with the internal auditors to enhance the external auditors' capabilities in conducting such *Shariah* compliance reviews as part of their audits. Most institutions offering Islamic financial services have their own internal auditors or *Shariah* reviewers who carry out this review, while some have their SSB or *Shariah* compliance review officers.

Another critical issue faced by IFIs is *Shariah* non-compliance risk. The concepts of *Mudarabah* (profit sharing) *Musharakah* (profit and loss sharing) and *Murabahah* (sales-based contracts) have contributed to a more complex risk management scenario. However, the IFIs are still struggling to translate the techniques of Islamic ethical checks into their

Shariah practices. The lack of measurement to audit the performance of IFIs in relation to the realization of *Maqasid al-Shariah* and the lack of guidelines on the subject from the regulators in the Islamic finance fraternity had left the industry to concentrate on the compliance of IFIs to *Shariah* resolutions on products and operational issues (Shafii *et al.*, 2015).

An internal *Shariah* audit is also required to add value and improve IFI compliance by providing an independent assessment and objective assurance. Previous researchers had found that independence, competence and work performance of ISA have an influence on their effectiveness (Al-Twaijry *et al.*, 2003; Alzeban, 2014; Mihret and Yismaw, 2007). Therefore, the objective of this paper is to examine conceptual relationship between competency of internal *Shariah* audit and effectiveness of internal *Shariah* auditors in IFIs. The paper presents the history of auditing in Islam, definitions, scope and practices of *Shariah* audit in IFIs, roles and responsibilities of *Shariah* auditors, followed by literature review along with the underlining theory and concluding remarks.

Literature review

The history of auditing in Islam

The first audience of Prophet Mohammad (p.b.u.h) was the trading community of Mecca. At that time, the principal commodity of trade in Arabia was money itself. Besides foreign exchange and trade, the other principal business was banking. The Thaqifs of Tai'f were famous bankers who lent heavy sums based on *riba*. The speculation in kinds and currencies was another favorite activity of the Quraysh. Although there were accounts of mass illiteracy among the Arabs in those days, a sheer stretch of imagination would suggest that these activities could not have been possible except by having some concepts of accounting and auditing. Thus, the concept of bookkeeping, mostly verbal, and rendering it to the Sahib Al-mal was in vogue among the Arabs; moreover, they were also aware of the concept of accountability (Khan, 1985).

The Hisba is a religious institution under the authority of the state that appoints people (the Muhtasibs) to carry out the responsibility of enjoining what is right, whenever people start to neglect it; and forbidding what is wrong, whenever people start to engage in it. The purpose is to safeguard the society from the deviance, protect the faith and ensure the welfare of the people in both religious and worldly manners according to *Shariah*. Allah (s.w.t) has made it obligatory upon all Muslims to enjoin good and forbid wrongdoing to the extent of their knowledge and abilities. The prophet (p.b.u.h) said:

Whosoever among you sees an act of wrongdoing should change it with his hands. If he is not able to do so, then he should change it with his tongue. If he is not able to do so, then with his heart, and this is the weakest of faith.

The function of Muhtasib was linked to Qur'an verses that urge Muslims to promote right and prevent wrong. Such as: 3:104: "Let there arise out of you, a band of people, inviting to all that is good, enjoining what is right, and forbidding what is wrong: They are the ones, to attain felicity," and in 59:7 "[...] So take what the Messenger assigns to you, and deny yourselves that which he withholds from you. And fear Allah; for Allah is strict in punishment." According to Imam Ghazali, Hisba practice must be seen as a fard kifayah for Muslims, where every Muslim is expected to play a positive role in the propagation of good (Ma'ruf) and suppression of evil (Munkar). However, it has been made an obligation on a section of society to remain engaged to it. Muhtasib is the official appointed by the ruler to implement Hisba on behalf of the state (Yaacob, 2012).

Definition and scope of Shariah audit

Shariah literally means, “The road to the watering place” or “the straight path to be followed,” and it is often equated with the Islamic law (Choudhury, 2005). *Shariah* provides a comprehensive guidance in regard to the human life and specifies the principles which aim to protect the interest of human being. *Shariah* presents both social contract and scientific groundwork for new global order that is premised on the episteme of Divine unity (Choudhury, 2005). According to one of the early studies on *Shariah* audit by Rahman (2008), *Shariah* audit is an independent assessment and objective assurance process that involves obtaining and evaluating sufficient and reliable evidence to establish whether activities and operations are in accordance with the established *Shariah* criteria, as well as recommending rectifications and improvements thereof. Thus, the need for *Shariah* audit stems from the requirement that the IFI should comply with *Shariah*. The following are the definitions, responsibilities, scopes and reporting relating to *Shariah* by the regulators and standards setters in Islamic finance (Table I).

Shariah audit practices in IFIs

At present, there are various *Shariah* audit practices in IFIs. For example, some have an internal *Shariah* audit unit; some outsource their internal *Shariah* audit to external *Shariah* auditors, while others conduct *Shariah* review. Thus, from the examination of the financial and non-financial statements of leading IFIs in Bahrain, it was found that most IFIs in Bahrain conducted *Shariah* review rather than *Shariah* audit. *Shariah* review in IFIs in Bahrain is conducted by SSB of the IFIs. However, in terms of auditing, only minimal percentage of IFI's SSB in Islamic banks in Bahrain indicated that the functions had been delegated to internal *Shariah* compliance unit (Shafii *et al.*, 2015). The IFIs in Bahrain do acknowledge the importance of a *Shariah* audit, and the AAOIFI has provided standards for SSB, *Shariah* Review and Internal *Shariah* Review under the Governance Standards (AAOIFI, 2010). GSIFI No.2 defines *Shariah* review as “an examination of the extent of an IFI's compliance, in all its activities, with *Shariah*. This examination includes contracts, agreements, policies, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc. (Para 3, GSIFI No. 2, AAOIFI Standards).” This could be seen as the most reflective description to define a *Shariah* audit.

At this point of time, it is important to clarify the different approach to *Shariah* review and *Shariah* audit between AAOIFI, IFSB and BNM. Starting with the AAOIFI Governance Standards, the GSIFI discusses “audit” in relation to audit of financial statements and refers to the term “*Shariah* review” exclusively as “IFI's compliance, in all its activities, with *Shariah*”. The IFSB, on the other hand, in its Guiding Principles in *Shariah* Governance Systems, interchangeably uses *Shariah* “audit/review.” In other words, audit and review have the same meaning. An example of how the IFSB interchangeably uses audit and review is: “An internal *Shariah* compliance review/audit is verifying that *Shariah* compliance has been satisfied, during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified.”

The BNM *Shariah* Governance Framework has assigned a separate definition to *Shariah* “audit” and “review.” As stated, *Shariah* audit is defined as 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 operation, with the main objective of ensuring a sound and effective internal control system for *Shariah* compliance.” The scope of *Shariah* audit includes an audit on the financial statements, a compliance audit on organizational

Table I.
Definitions,
responsibilities,
scope and report of
shariah audit

Items	AAOIFI	IFSB	BNM
Definition	Expression of opinion on financial statement that needs to be prepared in all material aspects, in accordance with the Fatwas, rulings and guidelines issued by the SSB, accounting standards of the AAOIFI, national accounting standard and practices, and relevant legislation and regulations applied in the country	Internal <i>Shariah</i> Review/Audit Unit (ISRU) to verify that <i>Shariah</i> compliance has been satisfied	Periodical assessment to provide independent assessment and objective assurance to add value and improve IFIs compliance in ensuring sound and effective internal control system of <i>Shariah</i> Compliance
Responsibility	Review of Internal Controls (including internal audit) plan. Review of interim and annual accounts and financial reports (inclusive of matters arising from the audit). Ensure IFIs adhere to AAOIFIs' Code of Ethics for Accountants and Auditors of IFIs. Review the compliance with <i>Shariah</i> rules and principles. Review the use of restricted investment accounts' funds. To assist the BOD in exercising independent and objective monitoring as follows: a. Preserving the integrity of financial reporting process. b. Safeguarding the interests of shareholders, investors, and other corporate stakeholders. c. Providing additional assurance on the reliability of financial information presented to the BOD. d. Acting as an independent link between the IFIs' managements and stakeholders	Record and report any incident of any non-compliance. Address and rectify any non-compliance activity. Shall require or recommend the management to address and rectify any issues regarding <i>Shariah</i> Compliance	To provide independent assessment and objective assurance as to add value and improve IFIs compliance in ensuring sound and effective internal control system for <i>Shariah</i> compliance includes: a. Assess efficiency and effectiveness of internal control system; b. Assess compliance to guidelines set by regulator; and c. Assess compliance to internal policies and procedures Develop comprehensive internal audit program or plan: Objective, scope, personnel assignment, sampling, control & duration. Establish proper audit processes. Obtain and make reference to relevant references <i>Shariah</i> Advisory Council rulings, <i>Shariah</i> Committee decision, Fatwas, guidelines, <i>Shariah</i> audit results & internal <i>Shariah</i> Checklist. Provide recommendations and follow-up on rectification measures taken by IFIs. To be performed by internal auditors who have acquired <i>Shariah</i> related knowledge and training. The internal auditors may engage the expertise of <i>Shariah</i> officers in performing the audit
Scope	The subject matter of <i>Shariah</i> audit covers not only financial statement but also akhlaq (ethics),	ISRU will review the products and services and	Audit of financial Statement of IFIs. Compliance audit on organizational structure, people and information technology <i>(continued)</i>

Items	AAOIFI	IFSB	BNM
Reporting	internal processes, personnel, financial and non-financial performance, financial position, information and IT systems, marketing and other relevant issues pertaining to <i>Shariah</i> . <i>Shariah</i> audit will provide additional assurance on the reliability of financial information presented to the Board Of Director. Audit report reflects the opinion of the auditor on the audited financial statements and on the IFI's accounting and other records	see if they adhered to the opinions of <i>Shariah</i> board ISRU shall report to the <i>Shariah</i> board. Produce reports indicating whether the Institution offering Islamic financial services (IFS) has complied with <i>Shariah</i> requirements throughout the financial year. Where appropriate, the ISRU reports shall require or recommend to the management of the IFS to address and rectify any issues of <i>Shariah</i> compliance	application system. Review adequacy of <i>Shariah</i> governance process <i>Shariah</i> audit findings shall be reported to the Board of Committee and <i>Shariah</i> Committee

Sources: AAOIFI (2010); IFSB (2009); and SGF (2010)

Table I.

structure, people, process and information technology application systems and a review of the adequacy of *Shariah* governance process. The framework of *Shariah* audit can be performed by IFI's internal auditors, "who have acquired adequate *Shariah*-related knowledge and training." On the other hand, "*Shariah* review" refers to regular assessment on *Shariah* compliance in the activities and operations of the IFI, with the objectives to ensure that the activities and operations carried out by the IFI do not contravene with *Shariah*." Thus, a *Shariah* review is specific to *Shariah* compliance in relation to the IFI's overall business operations and does not cover the entire financial statements. Unlike *Shariah* audit, *Shariah* review must be performed by a "qualified *Shariah* officer" who holds at least a bachelor's degree in *Shariah*, which includes a study in *Usul Al-Fiqh* (the origin of Islamic law) and *Fiqh Al-Muamalat* (Islamic transactions/commercial law). As can be seen from these two definitions, the difference between "audit" and "review" according to BNM is that an "audit" is an "independent" and "periodical" assessment, whereas for "review," there is no requirement of independence but there has to be a "regular assessment" (meaning more frequent than an audit) and it is related to "*Shariah* compliance" of the activities and operations carried out by the IFI.

Roles and responsibilities of internal *Shariah* audit

The responsibility of an internal auditor has recently been extended to include consultancy and assisting in corporate governance (Stewart and Subramaniam, 2010). The role has also been expanded to include *Shariah* audit in ensuring that the operations of IFIs are *Shariah*-compliant. This leads to the issues of independence and objectivity, as well as the competency of the internal auditor and auditor's performance in performing a new task as outlined in the AAOIFI standards. The role of auditors in the Islamic economy is totally different, as they are responsible to the society at large and to uphold the Islamic principles. The role of a conventional auditor in Islamic practices has been widely criticized by many Muslim scholars. Khan (1985) argued that the roles of a conventional auditor in the capitalist framework are solely to be answerable and provide assurance and attestation to the management and shareholders of the company particularly on financial matters. The importance of an internal *Shariah* audit in an IFI setting, especially in Islamic banks, leads various researchers to be concerned over its operation. The internal *Shariah* audit department is important in an Islamic bank as it is regarded as the backbone of the business accounting. This is because this section records all business transactions related to the sector. An organization that has an effective internal audit function will be much better than those organizations without such function especially in relation to fraud, detection and prevention (Corama *et al.*, 2006; Maria, 2012; Omar and Bakar, 2012). Al-Twajjry *et al.* (2003) indicated that the importance of having an effective internal audit is to ensure the achievement of organizational objectives.

The IFI auditors form and express an opinion on the financial statements after the completion of the *Shariah* review. The annual management report, the SSB report, and shareholders report are all dependent upon the auditor's report. Similar to auditors in conventional banks who are responsible for auditing the annual management reports, including financial statements, which are later presented to the shareholders during the annual general meeting, the IFI auditors have an additional responsibility of providing facts and evidence to the SSB for the preparation of the report to shareholders. The report is to be reviewed by SSB before it is presented to shareholders. As such, the auditors are not only responsible to the management but also the SSB. Besides performing financial statements audit, the auditors have to perform compliance audit on the organizational structure, people

and processes as well as audit review on the adequacy of the *Shariah* governance process, providing recommendation to the audit committee and governance (ACG) and SSB. While conventional auditors conduct their audit on the basis of samples, *Shariah* auditors have to ensure that the IFI has actually complied with Islamic precepts in all of its transactions before they can release the report. The IFI auditors are accountable not only for the manner in which the IFIs undertake their activities but also the effectiveness in which these activities contribute to the principle of *Shariah* to propagate the virtues of Islam in all areas of the institutions (Othman *et al.*, 2015).

Khan (1985) outlined some specific areas that Islamic auditors are expected to report. The list is non-exhaustive and as follows:

- *Determination of profit and loss*: It is a subjective and value-laden area in a business organization. The relevant standards of morality and integrity in the Muslim countries suggest that the auditors would have to operate in an extended field and verify an accurate figure of profit or loss which may not to be a strict compliance to the management's policies.
- *Managerial efficiency*: The auditors in the Islamic framework would report whether the management adopted prudent policies or not. They will have to lay down the principles of efficient managerial policies. For this purpose, auditors may have to manualize their standards.
- *Adherence to Shariah*: In the Islamic economy, the motive of profit maximization is substituted with maximization of the social good (Siddiqi, 1981). Thus, any business organization that generates social externalities adds to environmental pollution, depletes non-renewable resources or undertakes any operations is considered as illegal on the Haram–Halal continuum. This would be unacceptable from the Islamic point of view. The auditors in the Islamic framework would comment on this aspect as well. They would be required to testify that the organization has not indulged in any Haram activity or undertake any socially harmful operation. The specific areas in which the auditors may be enumerated as follows.
- *Tatfif*: It means causing damage to the other party in weights and measures. The *Shariah* does not allow this to happen; therefore, the auditor is supposed to check on the accuracy of the weights and measures.
- *Uquud*: It means contracts. Quran requires that all parties to the contract to adhere to the contract terms; therefore, the auditor is required to report if there is non-fulfillment of the terms of contracts.
- *Ihtikar*: It means hoarding. This is prohibited in Islam, specifically hoarding of foodstuffs with the intention of causing scarcity and bidding up prices artificially. The auditor should report any kind of hoarding being practiced.
- *Israf*: It means extravagance which is prohibited in Islam, thus requiring a report from the auditor if he observes that it is practiced by IFIs.
- *Khiyanah*: It means embezzlement. This does not only include embezzlement of funds, but also falsification of accounts, bogus insurance claims, tax evasions, window dressing and misstatements of accounts. The auditor is required to report on any form of *khiyanah* being practiced by the IFIs under audit.
- Determination and payment of Zakah. The idea is that Zakah is collected from the rich to be distributed to the poor as to ensure socio-economic justice through equitable distribution of wealth. Therefore, auditors need to observe the fair collection and distribution of Zakah.

- *Observance on Adl*: One of the objectives of the *Shariah* is the establishment of adl (justice) in the society. Auditors of the Islamic economy would be required to analyze impacts of the organizations' decisions and peace agreements on the level of existing inequalities and would recommend necessary changes to reduce them.
- *Reporting on Ihsan*: The socio-economic values of the Islamic economy include Ihsan. Ihsan in turn is a cluster of various values such as *amana* (honesty), *ithar* (sacrifice), *ta'awun* (cooperation), *sabr* (patience), *shukr* (thanksgiving), *tawakkul* (trust), *infaq* (spending), sila rahmi (joining of kinship ties), etc. In an Islamic economy, the adoption and promotion of Ihsan is one of the requirements of the *Shariah*.
- *Changes in accounting practices*: The extended role of audit in the Islamic framework would require suitable changes to the accounting practices. The format of accounting statements and the information disclosed by them would have to conform to the revised audit requirement. The auditors would make suitable recommendations on this aspect as well.

Internal *Shariah* audit effectiveness

According to [IIA \(2010\)](#), effectiveness can be defined as the degree including quality to which established objectives are achieved. The [BNM \(2011\)](#) defines effectiveness as an objective of ensuring a sound and effective internal control system for *Shariah* compliance. According to [AAOIFI \(2010\)](#), effectiveness is the performance of internal *Shariah* audit work such as ability to plan, implementation, document information, *Shariah* audit findings, recommendations, numbers of repeated reports, follow-up and evaluation of extent of *Shariah* compliance with Islamic *Shariah* rules and principles, Fatwas, guidelines and instructions by the IFI's SSB ([AAOIFI, 2010](#)). [Badara and Saidin \(2013\)](#) in their study highlighted a few definitions of the term, effectiveness. It means that internal audit effectiveness can be defined as the degree to which established objectives are achieved ([Badara and Saidin, 2013](#)). Most researchers agree that a program can be regarded as effective if its outcome goes along with its objective ([Ahmad et al., 2009](#); [Ussahawanitchakit, 2012](#)). Therefore, from the above definition, this study defined *Shariah* audit effectiveness or internal *Shariah* audit effectiveness as the ability of internal *Shariah* auditors to achieve established objective within IFIs.

Previous studies in *Shariah* audit had looked into the needs and challenges ([Rahman, 2008](#)), perceptions of academicians and practitioners towards *Shariah* audit ([Mulyany, 2008](#)), professionalization of *Shariah* auditor ([Shahul, 2013](#)), conceptualizing the duties and rules of *Shariah* auditors ([Othman et al., 2015](#)) and audit framework for *Shariah* compliance ([Shafii et al., 2010](#)). In addition, studies conducted on *Shariah* audit practices in IFIs focus on scope, competency, as well as work practices and the current framework used in performing *Shariah* audit ([Kasim et al., 2009](#); [Nik Suliman, 2012](#); [Yahya and Mahzan, 2012](#)). However, internal *Shariah* audit effectiveness has not been extensively studied compared to studies in external as well as internal audit in a conventional bank. This paper examines the relationship between competency and effectiveness of internal *Shariah* audit in IFIs. Currently, the *Shariah* audit and *Shariah* review process are done internally. The literature review related to internal *Shariah* audit effectiveness is adapted from previous studies. Previous research related to internal audit effectiveness had been conducted by [Ahmad et al. \(2009\)](#), [Arena and Azzone \(2009\)](#), [Badara and Saidin \(2014\)](#), [Endaya and Hanefah \(2013\)](#), [Mihret and Yismaw \(2007\)](#).

Anuar *et al.* (2009) found few factors that affect the effectiveness of internal audit in Malaysian public sector such as lack of training and support from management, lack of employees and negative perception of management toward the recommended solutions given by the internal auditors. In addition, internal audit effectiveness relates to the understanding of stakeholders' expectations towards the performance of an organization. It is found that the internal audit function could deliver an effective audit when the internal auditors understand the expectations of board of directors, CEO and operating management of the institutions (Feizizadeh, 2012). Effective professional internal *Shariah* auditors have the following characteristics: the ability to align the structure of internal *Shariah* audit with the dynamics of the Islamic banks' operations and a strong relationship between managerial skills to maintain appropriate and SSB needs and expectations. Besides the above, the level of training, education and experience, as well as professional qualifications of the internal auditors influenced the effectiveness of internal audit (Al-Twajiry *et al.*, 2003).

IFIs, especially Islamic banks, are concerned about their internal *Shariah* audits in ensuring the effectiveness of *Shariah* compliance, which in turn can positively contribute to the Ummah (society) at large (ISRA & Finance, 2013). Therefore, Islamic banks with effective and efficient internal *Shariah* audit function are better than those without the function to detect fraud within their organizations. Hence, an effective internal *Shariah* auditor is the one who assists IFIs in meeting their objectives. In view of this, IFIs should ensure that their internal *Shariah* audits are effective so as to create value and effectiveness in such organizations.

From the author's review of literature, no study has been conducted to examine the factors that contribute to the effectiveness of internal *Shariah* auditors in IFIs in Bahrain. Interpersonal skills, internal auditor's commitment and support from audit committee and BOD, audit performance and integrity, audit department efficiency, auditing competencies, internal auditor's knowledge on company's business operation and industry and auditor independence are found to be important attributes contributing towards internal audit function effectiveness (Ahmad *et al.*, 2009). An effective internal *Shariah* auditor assists in adding value and improving the performance of IFIs. This is based on the approaches of previous research (Al-Twajiry *et al.*, 2003; Arena and Azzone, 2009; Cohen and Sayag, 2010; Mihret *et al.*, 2010; Mihret and Yismaw, 2007).

Competence of internal *Shariah* audit

Competency can be classified as a dimension of behaviors related to superior job performance where certain people have better conduct than others. Competencies deal with behaviors that need to be displayed in order to do the job effectively. Competencies are also linked to technical skills, skills and knowledge to perform job particularly jobs with professional element (Woodruffe, 1993). Furthermore, competency can be generic or organization specific. Organization-specific competency refers to competencies related to certain managerial roles, list of universal competencies for top management as well as supra competencies (such as planning and organizing). Drejer (2001) proposed that competencies consist of four generic elements, namely, competency in the form of technology represents the tools that human beings use to do activities, human beings as the focal point for competency development, organization that prescribes the management systems and culture refers to the informal organization of the firm. Therefore, based on the various definitions, "competency" can be viewed as human being's capabilities or the expectation to perform certain tasks in an organization as well as the capabilities of a particular organization through its tools or system to perform certain functions in ensuring continuous operation of the organization. In light of *Shariah* auditor's competencies, there are certainly

specific *Shariah* auditing competencies that need to be mastered by the auditors in ensuring maximum performance is delivered to the bank's stakeholders.

According to the [AAOIFI \(2010\)](#):

the auditor shall be knowledgeable about Islamic *Shariah* rules and principles. However, he/she would not possess the same level of knowledge as that of SSB members; and thus the auditor shall not be expected to provide interpretation of these (Islamic) rules and principles. The Fatwas, rulings and guidance issued by the SSB form the basis on which the auditor considers whether the IFI has complied with the Islamic *Shariah* rules and principles. The auditor shall also use this as a basis for concluding whether the financial statements of the IFI have been prepared in accordance with the Islamic *Shariah* rules and principles.

The internal *Shariah* auditors shall possess the discipline, knowledge and skills essential to the performance of internal *Shariah* audit. Proficiency in Islamic *Shariah* rules and principles in general, and *Fiqh Al-Muamalat* in particular, is required in performing internal *Shariah* audit. The internal *Shariah* auditors shall maintain their technical competence through continuing education; they shall also participate in training their IFI's employees and other interested members of the public by holding regular meetings, courses and seminars. They may also explain principles of *Fiqh Al-Muamalat* in general and in particular Fatwa, guidelines and instructions issued by SSB about the products and services offered by their IFI ([AAOIFI, 2010](#)). To date, the lack of both *Shariah* and accounting knowledge has decayed the crucial needs for internal *Shariah* auditors. Those with accounting knowledge tend not to have *Shariah* knowledge and vice versa ([Yaacob, 2012](#)).

It is difficult to have a qualified internal *Shariah* auditor because there is a lack of specialized education, skill or training programs of *Shariah* audits that could fulfill the needs of the IFIs and regulators ([Kasim, 2009](#)). Internal *Shariah* auditors are not reliable due to the poor knowledge or their dependence on bank management. There is an insufficient internal *Shariah* auditor in the market, even if available, they are found to be lacking in independence and competence. A good internal *Shariah* auditor should have both *Shariah* and accounting qualifications. Internal *Shariah* auditors also lack work performance ([Kasim et al., 2009](#); [Shafii et al., 2013](#)).

Shariah audit teams that conduct *Shariah* audit, in most cases, are not *Shariah* qualified. However, they claim to have been exposed to the concepts, policies and ethics of Islam and work closely with *Shariah*-qualified officers in *Shariah* departments or compliance units ([Kasim and Sanusi, 2013](#)). The ultimate empirical questions to be raised are as follows: who are considered as a qualified internal *Shariah* auditing expert and what are the borders of authenticated knowledge. It is the duty of an internal *Shariah* auditor to use the best of his professional abilities to gain related knowledge of the profession. In addition, the internal auditors who are attached to IFI must not only have auditing skills but also need to have an additional qualification, which is *Shariah* knowledge specifically in *Fiqh Al-Muamalat* ([Shafii et al., 2014](#)). *Shariah* knowledge is fundamental to the internal auditors especially when they are involved in the *Shariah* auditing process ([Yahya and Mahzan, 2012](#)). There is a need for an education and training program that provides relevant basic knowledge in *Shariah* accounting and auditing; but most *Shariah* auditors do not possess both qualifications ([Kasim et al., 2009](#); [Rahman, 2011](#)). The actual practices of *Shariah* audit in IFIs depend on the internal *Shariah* auditors or the management of the *Shariah* unit ([Kasim et al., 2009](#)). One of the main issues is the lack of competence to perform an effective internal *Shariah* audit. It was found that the current internal *Shariah* auditors lacked the *Shariah* background and scope of audit needed to be performed by internal auditors ([Shafii et al., 2014](#)).

Shafii *et al.* (2013) found that the competency of *Shariah* auditor shall be determined by each IFI, as well as being well equipped with both accounting and *Shariah* knowledge. It should be noted that an internal *Shariah* auditor must have both good knowledge in accounting and *Shariah* to be able to understand and audit the IFIs. Another study done by Haron *et al.* (2004) examined the criteria used by external auditors to evaluate the work of internal auditors and found that competency of internal auditors is an important criteria for external auditors in judging the reliability of internal audit's work. In this study, they used professional certification or qualification and training program as the proxies of competence.

Flint (1988) stated that audit competency requires both knowledge and skill, which are products of education, training and experiences. Carrying out responsibilities with competence and due care is consistent with the Hadith: "God loves those, when they do ask, they do it perfectly." Competences cover a wide aspect. However, it could be interpreted that technical competency alone would be insufficient in playing the expected role and achieving the anticipated results within the framework of *Shariah* Islamiah as established criteria (Kasim, 2009). Investments in the education of *Shariah*, accounting and auditing are especially crucial to enhance the knowledge and expertise of the actors involve with *Shariah* audit, and IFIs in general (Rahman, 2011; Sulaiman, 2011). Hanim Fadzil *et al.* (2005) suggested that when internal auditors have professional proficiencies such as adequate knowledge, professional membership, certification and training in electronic data processing systems, it would imply that they are competent to monitor the quality of the internal control system.

Shafii *et al.* (2010) stated that successful audit depends on the strength of human resources such as having competent and credible experts to set the work and review the results. As such, there is an urgent need for a proper training on *Shariah* concepts as most of the banks officers are from conventional background. Therefore, they do not understand how to apply *Shariah* concepts and run the risk of providing wrong information on the banking products to their clients (Abdul Rahman, 2006). There is a need to expand the talent pool of *Shariah* audit knowledge and competencies. Hence, previous studies suggested that there is a need to integrate *Shariah* audit as a part of curriculum offered to accounting students (Abdul Rahman, 2006; PwC, 2011).

Audit experience refers to different kind of knowledge and skills which an auditor obtains as a result of extensive experience gained from his auditing work that enhances his effectiveness (Mihret and Yismaw, 2007). It is defined as an auditor's unique knowledge, competencies and capabilities acquired from his auditing job (Ussahawanitchakit, 2012). Also, audit experience influences hypotheses generation, especially industry experience. Industry experience resulted in the auditors to being efficient and effective by knowing the unique risks and audit approaches of a particular industry (Wright and Arnold, 1997); for example, the *Shariah* incompliance risk which is unique to IFIs. *Shariah* audit experience is an essential factor to be considered when it comes to internal *Shariah* audit effectiveness. This is because it enables *Shariah* auditor to provide good *Shariah* audit results and good recommendation. In addition, it enhances the internal *Shariah* auditor's discipline, knowledge and skills essential to the effectiveness of internal *Shariah* auditor; proficiency in Islamic *Shariah* rules and principles in general, and *Fiqh Al-Muamalat* in particular, is required in performing internal *Shariah* audit (AAOIFI, 2010). When an internal *Shariah* auditor has many years of experience, he/she can make a right and prompt decision and deal with any situation. Consistent with the Islamic agency theory and its proponents, expert internal *Shariah* auditors help in IFI growth because they have clear insights dealing with the process and accomplishing their tasks with superior quality (Safieddine, 2009).

Thus, the internal auditors who are attached to the IFI must not only have the qualification of *Shariah* knowledge but also need to have additional *Shariah* auditing experience, skills and training. The effectiveness of internal *Shariah* auditors depends substantially on their quality, training and experience. Thereafter, steps should be taken to provide the necessary experience, training and continuous professional education (Shafi *et al.*, 2014). Thus, internal *Shariah* auditors with more *Shariah* audit experience tend to conduct excellent audit practices, achieve superior audit outcomes and gain outstanding audit success. Research on the area of professional experience in accounting and auditing is increasing (Gaballa and Ning, 2011). Therefore, future research needs to conduct research on such audit experiences (Ussahawanitchakit, 2012). Furthermore, Badara and Saidin (2013) emphasized on the validation of such relationship empirically. Practically, this should also be an area of research in IFIs. Various researchers have postulated that audit experience does impact internal audit issues (Al-Twajry *et al.*, 2003; Wang *et al.*, 2012; Wiliam, 1983). A study done by Mu'az saidu (2014) on the internal audit effectiveness from the Nigerian perspective found that audit experience has a significant positive relationship with internal audit effectiveness. Auditors with more experience have a good comprehension of decision process and place greater reliance on the net income variable. Libby and Frederick (1990) found that experienced auditors have the ability to give more explanations on audit findings.

Kasim and Sanusi (2013) suggested that *Shariah* auditors should have specialized qualifications both in *Shariah* and accounting. They suggested that CPA firms that audit IFIs should have the necessary technical accounting qualifications. One of their recommendations was that the university must include *Shariah* auditing courses in its syllabus or introduce a double major in accounting and *Shariah* so that future accountants or auditors have the necessary skills and knowledge of *Shariah* audit. In addition, Najeeb and Ibrahim (2013) argued on the need for *Shariah* auditing by creating an Association of Chartered *Shariah* Accountants and Auditors (ACSAA). This will result in economic benefits in the long run. It is important that the internal *Shariah* auditors working in IFIs by nature be good Muslims and must know *Shariah* requirements related to the institution's operations. Rahman (2011) stated that the internal *Shariah* auditors should possess an adequate auditing knowledge, skills and competencies regarding the following:

- proficiency in applying internal auditing standards and procedures;
- proficiency in accounting principles and techniques;
- understanding of management principles;
- appreciation of accounting, economics, commercial law, taxation, finance, quantitative methods and IT;
- skills in dealing with people and communicating; and
- skills in oral and written communication.

Thus, the process of *Shariah* auditing will be more effective and sound, if the internal auditor has relevant and adequate knowledge on Islamic *Fiqh Al-Muamalat* and Islamic legal contract/maxims. The knowledge of these two areas will enhance the process of the auditing as the internal auditor will be more appreciative and alert on the issues of *Shariah* non-compliance (Yahya and Mahzan, 2012). Because IFIs have a unique role, the *Shariah* auditor should ideally be knowledgeable in both *Shariah* (Islamic law) and *Fiqh Al-Muamalat* (commercial and accounting practices). *Shariah* is divine law, while *Fiqh* is a product of human understanding of the *Shariah*. *Fiqh* has now become the legacy of Islamic

law that covers almost all areas of law pertaining to the “Islamic way of life” including financial contract of products (Bakar, 2006).

Banaga *et al.* (1994) stated that to serve the Muslim community and society, IFIs should recruit those who are good Muslims, competent and possess good knowledge of *Shariah*; and the banks should also only conduct business transactions with those high moral customers whose activities are in accordance with the principles of *Shariah*. However, in practice, it appears that very few internal auditors are well versed in both disciplines. In summary, competence is one of the important characteristics of internal *Shariah* audit. Hence, the competency of internal *Shariah* audit is conceptualized as the skills necessary to be performed through educational qualification and experience on the job. Previous studies had measured competency of internal *Shariah* audit, e.g. professional qualifications, educational qualifications, experience, skills and training (Kasim, 2009).

Thus, the effectiveness of internal *Shariah* audit depends substantially on the quality, training, skills and experience of its staff. The aim should be directed toward the appointed staff with appropriate accounting and *Shariah* background, personal quality and potential. Therefore, steps should be taken to provide the necessary experience, training and continuous professional education. No previous studies have examined the relationship between competency and effectiveness of internal *Shariah* auditors in IFIs. In summary, this paper determines the relationship between internal *Shariah* audit competency and internal *Shariah* audit effectiveness in IFIs. A greater internal *Shariah* audit effectiveness is expected to be achieved through competency of internal *Shariah* auditors.

Proposition

P1. Competency positively impacts internal *Shariah* audit effectiveness in IFIs.

P1a. Each dimension of competencies is positively related to internal *Shariah* audit effectiveness.

Theoretical framework

Based on the above discussion, the study’s theoretical framework is shown in Figure 1.

Maqasid al-Shariah theory

The idea of *Maqasid al-Shariah* or higher objectives of Islamic law have gradually captured the attention of an increasing number of modern Muslim scholars in solving contemporary issues. This paper adopts Abu Zaharah’s (1997) theory of *Maqasid al-Shariah* that perceives the objective of *Shariah* as mercy (Rahmah) to mankind, as confirmed by Quranic verse, “We have not sent you thee but as mercy to the whole world (al’amin)” (al-Quran, Al-Anbiya’, 21:107). Abu Zaharah’s general theory of *Maqasid al-Shariah* encompasses and

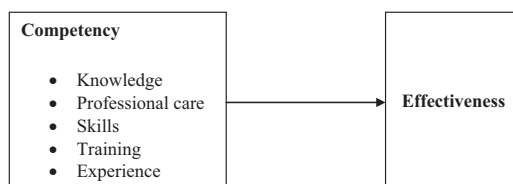


Figure 1.
Theoretical
framework

transcends all barriers that divide humanity, regardless of their beliefs and cultural backgrounds (Mustafa, 2011).

Competency of internal *Shariah* audit (in terms of knowledge, educational qualification, skill, experience and training) seems to be the foundation for internal *Shariah* audit effectiveness in Islamic banks to achieve the objective of *Maqasid al-Shariah*, similar to Abu Zaharah who regards educating individual (*Tahdhib al-Fard*) as an important element for transforming the individual (internal *Shariah* auditor) into a useful member of the society (by being effective) who would also refrain from causing harm to others. He says, “the *Shariah* and all its institutions are meant to educating human beings.” These institutions include the prescribed acts of worship (*ibadat*) such as prayers (*salah*), Zakat, fasting (*saum*) and pilgrimage (Haj) as a part of the Islamic educational program. Therefore, Islam primarily focuses on individual as an important building block of the society. Proper education for *Shariah* auditor (knowledge, educational qualification, skill, experience and training) will result in an effective internal *Shariah* audit to an IFI.

Abu Zaharah classified his three specific objectives as follows:

- (1) *Educating the individual (Tahdhib al-Fard)*: The injunctions of *Shariah* aim to educate the individuals and inspire them with faith and instill in them the qualities of being trustworthy and righteous. It is through reforming the individuals that Islam aims at achieving its social goals. In matters related to *Muamalah*, all the injunctions of *Shariah* are geared toward achieving the objective of educating the people by adhering to the principle of justice, trustworthiness, honesty and social responsibilities. Justice in Islamic institutions results in these characteristics being applied to those involved in the management of financial resources and recording of financial transactions. Similarly, these are also related to those who substantiate and validate the work of the management, i.e. the *Shariah* auditors who are the focus and the subject of this study.
- (2) *Upholding justice (Adalah)*: This is another objective of *Shariah* which aims at achieving the social goals. *Adalah* means placing things in their rightful place where they belong, thus establishing a balance by way of fulfilling rights and obligations and by eliminating excess and disparity in all spheres of life (Laldin, 2006). The Qur’an emphasizes that Muslims should be just in their relationship with everyone, even with their enemy: “O you who believe, Stand out firmly for Allah and be just witnesses and let not the enmity and hatred of others make you avoid justice. Be just: that is nearer to pity, and fear Allah. Verily, Allah is well acquainted with what you do” (5:8). In relation to the work of an auditor, if he adds or removes a word or a letter or misinterprets a word, he could cause damage and benefit those who do not deserve them, and this may damage the interest of innocent people (Abdullah, 2000). Therefore, *Adalah* should be a straightforward requirement in the appointment of *Shariah* auditors to ensure that they are reliable, trustworthy and can express their opinions without bias or prejudice.
- (3) *Public interest (Maslahah)*: Public interest/human welfare or *Maslahah* is the ultimate goal for all the *Shariah* branches. In other words, the *Shariah* in its entirety ultimately aims at promoting *Maslahah*, which must be real or genuine and should promote benefits to the larger section of the society and preventing haram (Mohammed, 2011). An individual can elevate himself spiritually above his animalistic desire allowed by religion. Through religion, man will be able to control his excessive desire for wealth and sacrifice the surplus for the welfare for the less privileged members of the society. Thus, the *Shariah* audit should ensure

that the IFI policies and programs on public interest be taken into consideration and be an important element in their business objectives of corporate social responsibility.

These three classifications by Abu Zaharah can easily measure results at the individual and institutional levels, Muslim and non-Muslim alike. These three objectives are universal in their application. Therefore, Abu Zaharah's theory will suit this study because of its comprehensiveness, universality and dynamism (Mustafa, 2011). Hence, competency of internal *Shariah* audit (in terms of knowledge, educational qualification, skill, experience and training) seemed to be the foundation for internal *Shariah* audit effectiveness in Islamic banks to achieve the objective of *Maqasid al-Shariah*, similar to Abu Zaharah who regard educating individuals (*Tahdhib al-Fard*) as an important element of transforming the individual (internal *Shariah* auditor) into a useful member of the society (by being effective) who would also refrain from causing harm to others. He says, "*Shariah* and all its institutions are meant to educating human beings. These institutions include the prescribed acts of worship (Ibadat) such as prayers (Salah), Zakat, fasting (saum) and pilgrimage (Haj) as part of the Islamic educational program. Therefore, Islam focuses on individual as the important building block of society. Proper education for *Shariah* auditor (knowledge, educational qualification, skill, experience and training) will result in an effective internal *Shariah* audit to an IFI.

Based on the above discussion, the effectiveness of internal *Shariah* audit as seen from the context of Abu Zaharah's theory is multidimensional; they address both material and spiritual needs of man. Internal *Shariah* auditors must ensure fair dealings in all business activities, which include product, pricing and contract terms and conditions. In addition, internal *Shariah* auditors must ensure that all Islamic activities are free from negative elements that may cause injustice, such as *riba*, gambling fraud and corruption (Mustafa, 2011).

The proposed framework of this paper may enable researchers, scholars and internal *Shariah* auditors to understand how the salient *Maqasid Al Shariah* theory can be applied as the basis for a theoretical framework of this study. This theoretical framework is developed to provide more insight into the contributing factors that will affect internal *Shariah* audit effectiveness. Consequently, this framework will contribute to the body of literature by extending the needs for more empirical internal *Shariah* audit research in the future. This proposed framework adds to the growing body of international literature related to the relationship among various corporate *Shariah* governance mechanisms, namely SSB, AGC and internal *Shariah* audit. Thus, this is the first type of research conducted in IFIs. Therefore, from a practical perspective, this proposed framework provides feedback to the regulators, e.g. AAOIFI and IFSB, on the need for *Shariah* rules and principles that support and enhance the internal *Shariah* audit in an IFI and the relationship between the SSB and the internal *Shariah* audit.

Conclusion

This paper presents the conceptual relationship between competency and effectiveness of internal *Shariah* auditors in IFIs. The paper considers competency as the only independent variable; this paper is a conceptual literature review of IFIs. However, despite limitations, this paper contributes to the knowledge of *Shariah* auditing by extending the existing literature review on internal *Shariah* audit effectiveness. This is done by determining the effectiveness of internal *Shariah* auditors at IFIs in relation to

competency of internal *Shariah* auditors; and as recommended, more research should be carried out on the effectiveness of internal *Shariah* auditors. Likewise, future research should look into the possibility of introducing other variables such as independence, work performance of internal *Shariah* auditors on the strength or influence on the relationship between competency and effectiveness of internal *Shariah* auditors. In addition, further research should be conducted on internal *Shariah* audit effectiveness.

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Corresponding author

Azam Abdelhakeem Khalid can be contacted at: azamabelhakeem@yahoo.com

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