

**AN ANALYSIS OF THE EFFECTIVENESS OF THE
INTERNAL SHARIAH AUDIT FUNCTION IN
MALAYSIAN ISLAMIC FINANCIAL INSTITUTIONS**

BY

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ABSTRACT

An effective internal Shariah audit function in Islamic Financial Institutions (IFIs) is imperative to ensure better management of the Shariah non-compliance risks through a more robust Shariah audit practices. The accountabilities of the Board and Shariah Committee members are also vital to provide effective oversight on the internal Shariah audit function. The primary objective of this research is to evaluate the extent of the effectiveness of the internal Shariah audit function in IFIs in Malaysia. By using contingency theory, the study also examines the antecedents of an effective internal Shariah audit function. Consequently, the impacts of an effective internal Shariah audit function on the extent of Shariah governance and Shariah compliance disclosure in the Statements by Directors and Shariah Committee Report are examined based on the accountability theory. The study adopts a quantitative research method using a survey questionnaire and content analysis of the annual reports of IFIs in Malaysia. The total population of 47 IFIs during the period of data collection, i.e. the year 2016, were observed as the unit of analysis and the targeted sample. Survey questionnaires were distributed to the Heads of Shariah audit who are the key representatives of the internal Shariah audit function in IFIs in Malaysia. The findings indicate that the majority of IFIs have established an effective level of internal Shariah audit function. The internal control system is found to be the dominant contingent factor to contribute positive and significant effects to the effective internal Shariah audit function. There are positive but not significant effects between the Shariah risk management function, management support, and the function of Shariah Committee members on the effective internal Shariah audit function. The study also found that an effective internal Shariah audit function has a positive effect on the Shariah governance and Shariah compliance disclosures in the Statements by Directors and Shariah Committee Report. However, the effects are also not significant. The majority of IFIs have disclosed a minimum level of Shariah governance and Shariah compliance information in the Statements by Directors and the Shariah Committee Report. In conclusion, an effective internal Shariah audit function indicates the robustness of the Shariah audit practices and better management of Shariah non-compliance in the IFIs. The findings contribute to the need of rigorous monitoring and more attention by Bank Negara Malaysia as the regulator on the effectiveness of the internal Shariah audit function performed by the Takaful operators and Islamic windows in commercial and investment banks. This further emphasises the crucial need for a holistic Shariah compliance culture in IFIs to enhance the effective internal Shariah audit function and ultimately, enhance the integrity and accountability of IFIs.

خلاصة البحث

تعتبر وظيفة التدقيق الشرعي الداخلي الفعال في المؤسسات المالية الإسلامية أمراً ضرورياً لضمان إدارة أفضل لمخاطر عدم الامتثال للشريعة من خلال ممارسات تدقيق شرعية أكثر قوة. تعد مساءلة أعضاء مجلس الإدارة وأعضاء اللجنة الشرعية أمراً حيوياً أيضاً لتوفير رقابة فعالة على وظيفة التدقيق الشرعي الداخلي. الهدف الأساسي من هذا البحث هو تقييم مدى فعالية وظيفة التدقيق الشرعي الداخلي في المؤسسات المالية الإسلامية في ماليزيا. باستخدام نظرية الطوارئ، تبحث الدراسة أيضاً في السوابق لوظيفة التدقيق الشرعي الداخلي الفعالة. ونتيجة لذلك، يتم فحص تأثيرات وظيفة التدقيق الشرعي الداخلي الفعالة على مدى الحوكمة الشرعية والإفصاح عن الامتثال لأحكام الشريعة في بيانات أعضاء مجلس الإدارة وتقرير اللجنة الشرعية بناءً على نظرية المساءلة. تتبنى الدراسة أسلوب البحث الكمي باستخدام استبيان المسح وتحليل محتوى التقارير السنوية للمؤسسات المالية الدولية في ماليزيا. تمت ملاحظة ٤٧ مؤسسة مالية إسلامية خلال فترة جمع البيانات، أي عام ٢٠١٦م، كوحدة للتحليل والعينة المستهدفة. تم توزيع استبيانات المسح على رؤساء التدقيق الشرعي الذين يعتبرون الممثلين الرئيسيين لوظيفة التدقيق الشرعي الداخلي في المؤسسات المالية الإسلامية في ماليزيا. تشير النتائج إلى أن غالبية المؤسسات المالية الإسلامية قد أنشأت مستوى فعالاً لوظيفة التدقيق الشرعي الداخلي. كما وجدت أن نظام الرقابة الداخلية هو العامل المحتمل المسيطر الذي يساهم في إحداث تأثيرات إيجابية وهامة في وظيفة التدقيق الشرعي الداخلي الفعال. هناك تأثيرات إيجابية ولكن ليست جوهرية بين وظيفة إدارة المخاطر الشرعية ودعم الإدارة ووظيفة أعضاء اللجنة الشرعية على وظيفة التدقيق الشرعي الداخلي الفعال. كما وجدت الدراسة أن وظيفة التدقيق الشرعي الداخلي الفعال لها تأثير إيجابي على الحوكمة الشرعية والإفصاح عن الامتثال لأحكام الشريعة في بيانات أعضاء مجلس الإدارة وتقرير اللجنة الشرعية. ومع ذلك، فإن التأثيرات ليست كبيرة أيضاً. أفصحت غالبية المؤسسات المالية الإسلامية عن الحد الأدنى من معلومات الحوكمة الشرعية والامتثال لأحكام الشريعة في بيانات أعضاء مجلس الإدارة وتقرير اللجنة الشرعية. ختاماً، تشير وظيفة التدقيق الشرعي الداخلي الفعال إلى قوة ممارسات التدقيق الشرعي والإدارة الأفضل لعدم الامتثال للشريعة في المؤسسات المالية الإسلامية. تساهم النتائج في أن هناك حاجة إلى مراقبة صارمة ومزيد من الاهتمام من قبل بنك نيغارا ماليزيا (البنك المركزي الماليزي) بصفته المنظم لفعالية وظيفة التدقيق الشرعي الداخلي التي يقوم بها مشغلو التكافل والنوافذ الإسلامية في البنوك التجارية والاستثمارية. وهذا يؤكد كذلك على الحاجة الماسة لثقافة شاملة للامتثال للشريعة في المؤسسات المالية الدولية لتعزيز وظيفة التدقيق الشرعي الداخلي الفعال، وفي نهاية المطاف، تعزيز نزاهة ومساءلة المؤسسات المالية الإسلامية.

APPROVAL PAGE

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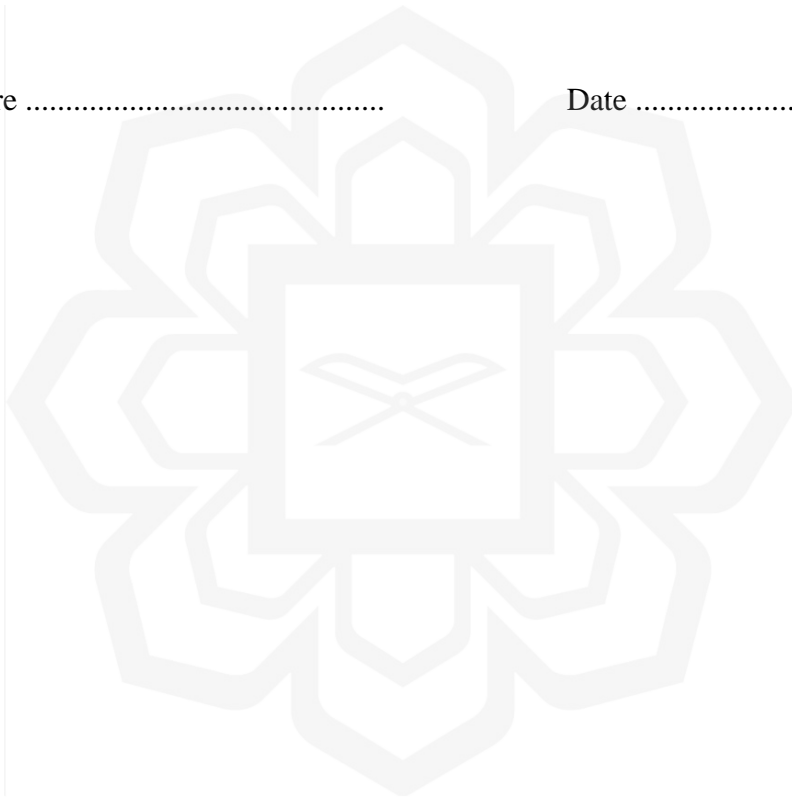
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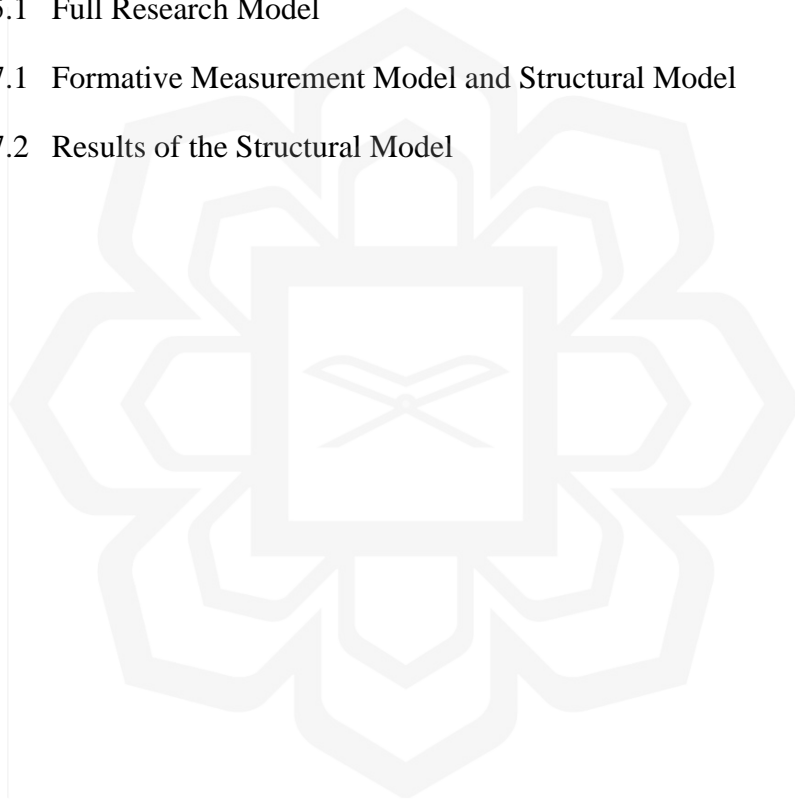
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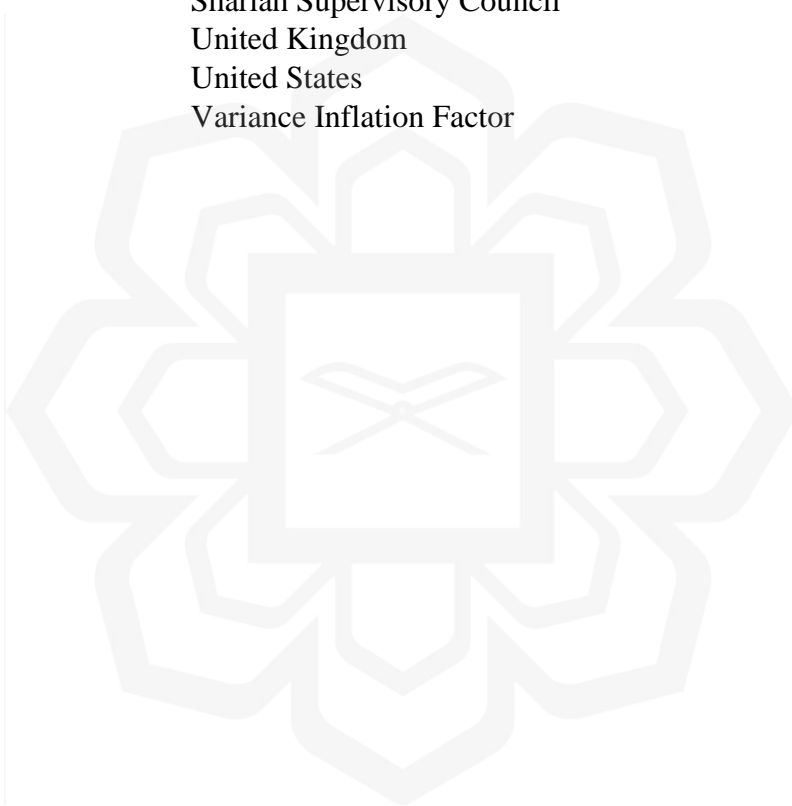
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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organizations for Islamic Financial Institutions
ACCA	Association of Chartered Certified Accountants
ACSSA	Association of Chartered Shariah Accountants and Auditors
ASAS	Association of Shariah Advisors in Islamic Finance
BIB	Bahrain Islamic Bank
BIMB	Bank Islam Malaysia Berhad
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia
CAE	Chief Audit Executive
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CGF	Corporate Governance Framework
CIA	Chief Internal Auditor
CIFP	Chartered Islamic Finance Professional
CIMA	Chartered Institute of Management Accountants
	Committee of Sponsoring Organizations of the Treadway Commission
COSO	
CRSA	Control Risk Self-Assessment
DFIA	Development Financial Institutions Act
DFIs	Development Financial Institutions
DFUs	Deficit Fund Units
ERM	Enterprise Risk Management
FRIBI	Financial Reporting for Islamic Banking Institutions
FRTO	Financial Reporting for Takaful Operators
GAAP	Generally Accepted Accounting Principles
GAIN	Global Auditing Information Network
GPS1-i	Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions
IBA	Islamic Banking Act
IBFIM	Islamic Banking and Finance Institute Malaysia
IBs	Islamic Banks
ICAEW	Institute of Chartered Accountants in England and Wales
IFIs	Islamic Financial Institutions
IFRS	International Financial Reporting Standards
IFSA	Islamic Financial Services Act
IFSB	Islamic Financial Services Board
IIA	Institute of Internal Auditors
INCEIF	International Centre for Education in Islamic Finance
IPPF	International Professional Practices Framework
ISAF	Internal Shariah Audit Framework
ISRA	International Shariah Research Academy
IT	Information Technology

KSOC	Knowledge, Skills and Other Characteristics
MFRS	Malaysia Financial Reporting Standards
OECD	Organisation for Economic Co-operating and Development
PLS-SEM	Partial Least Squares - Structural Equation Modelling
SAC	Shariah Advisory Council
SC	Securities Commission
SFUs	Surplus Fund Units
SGF	Shariah Governance Framework
SGPD	Shariah Governance Policy Document
SOPs	Standards Operating Procedures
SPPIA	Standards for Professional Practice of Internal Auditors
SPSS	Statistical Package for the Social Sciences
SSB	Shariah Supervisory Board
SSC	Shariah Supervisory Council
UK	United Kingdom
US	United States
VIF	Variance Inflation Factor



CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The internal Shariah audit function is a significant mechanism within the Shariah Governance Framework (SGF, 2010) issued by Bank Negara Malaysia (BNM) for Islamic Financial Institutions (IFIs) in Malaysia. Based on the SGF (2010), the internal Shariah audit function performs an independent assessment and provides objective assurance that the IFI's business operations are Shariah compliant. To achieve the Shariah compliance objective, it is crucially important for the internal Shariah audit function to be effective. Effective functioning is associated with the degree to which a group of people or organisations achieve the desired objectives. Therefore, an effective internal Shariah audit function is imperative to ensure better management of the Shariah non-compliance risks through a more robust Shariah audit practices. When the internal Shariah audit function is effective, the Board of Directors and Shariah Committee members have the accountability to provide relevant information on the extent of Shariah compliance to the institutional shareholders and stakeholders in general.

Over the years, IFIs in Malaysia have emerged tremendously to provide financial mechanisms that are in line with the Shariah principles for the Muslim population in Malaysia. The establishment of Tabung Haji back in 1969 provided the first solution for the Muslim population to save in an Islamic savings institution for the purpose of pilgrimage. In 1983, Bank Islam Malaysia Berhad (BIMB) was established as the first IFI in Malaysia to offer Islamic financial products and services. Hence, IFIs in Malaysia have developed to offer Islamic financial mechanisms for the stakeholders to achieve the important objective of Shariah compliance in their Islamic financial activities. After

almost five (5) decades, immense development of IFIs in Malaysia can be observed within the local and global financial landscape to offer Islamic financial products and services to the Muslim as well as the non-Muslim population. The fundamental nature of IFIs, which were established based on the Shariah principles, considerably increased the interest of stakeholders to participate in Islamic financial activities and operations. The importance of Shariah compliance is rendered among the stakeholders who highly valued and benefited from the Islamic financial products and services offered in IFIs. Shariah compliance is of crucial importance to protect stakeholders' interests in IFIs (Grais & Pellegrini, 2006).

The crucial need for the IFIs to ensure Shariah compliance in their Islamic financial activities and operations cannot be undermined. This is due to the fact that IFIs in Malaysia have a significant role to play within the Islamic financial development of the nation. IFIs are mandated to operate based on the Shariah principles not only in terms of offering Islamic financial products and services but also the whole operational structure of IFIs. In a nutshell, IFIs are crucially accountable to ensure that the substance of the IFI's business operations is dealt in accordance with the Shariah principles, not only in terms of its legal form. In a competitive business environment and dual financial system in Malaysia, Shariah compliance is perceived to be of the utmost importance to enhance the distinctive features of IFIs as compared to their conventional counterparts. IFIs in Malaysia were established in various forms to operate Islamic financial activities and operations. This includes the full-fledged Islamic banks (IBs), Islamic subsidiaries of conventional banks, Islamic windows in commercial and investment banks, and Islamic banking businesses in Development Financial Institutions (DFIs), as well as Takaful operators and Retakaful operators.

In addition, stringent regulations and guidelines are issued by BNM as the regulator. This is important to ensure that these various forms of IFIs operate based on the Shariah principles to gain significant trust and confidence from the stakeholders. BNM has issued SGF (2010) to enhance the Shariah governance practices in all IFIs. The SGF (2010) is important to uphold the integrity of IFIs, and aims at ensuring that the whole Islamic financial system and all activities operate within the Shariah boundaries. Since then, each IFI has established the SGF (2010) and set its primary objective to ensure that its Islamic financial activities and operations are Shariah compliant. This is achieved through enhancing the role of the Board, Shariah Committee members, and management to be accountable for Shariah matters in IFIs. In addition, IFIs have also established the Shariah compliance functions consisting of the Shariah review, Shariah risk management, Shariah audit, and Shariah research functions with their respective responsibilities to achieve the objective of Shariah compliance.

In the context of IFIs, the Shariah audit function is highly accountable in terms of conducting an independent assessment and providing objective assurance concerning an effective internal control system and the IFI's business operations in respect of Shariah compliance. The SGF (2010) has outlined that the objective assurance provided by the internal Shariah audit function in each IFI needs to be communicated to the Board through the Board Audit Committee and Shariah Committee members. The opinion concerning objective assurance for Shariah compliance is then reported in the Shariah Committee Report of each IFI (Bank Negara Malaysia, 2010b). This emphasises that the internal Shariah audit function must be effective to ensure better management of Shariah non-compliance risks. Otherwise, IFIs are exposed to Shariah non-compliance risks which will affect their credibility and integrity to conduct Islamic business operations.

As a consequence, an effective internal Shariah audit function and Shariah compliance process that were conducted during the year will be reflected and disclosed in the annual report. The institutional shareholders and stakeholders will be informed of the extent of Shariah non-compliance risks management and effective internal Shariah audit practices in the IFI's business operations by the Board of Directors and Shariah Committee members. At the moment, although the full-fledged IBs have established acceptable internal Shariah audit practices, only limited internal Shariah audit practices are found in most Islamic subsidiaries of conventional banks (Ab Ghani & Abdul Rahman, 2015). After half a decade of establishing the SGF (2010), it is pertinent to evaluate the effectiveness of the internal Shariah audit function to enhance the confidence of stakeholders in respect of the Shariah compliance of IFI's business operations. Recently, the Shariah Governance Policy Document (SGPD, 2019) is issued by BNM to strengthen the effectiveness of the Shariah governance practices in IFIs.

1.2 PROBLEM STATEMENT

Research related to IFIs in Malaysia has gained an enormous amount of attention from academic scholars over the past few decades. The rapid development of IFIs in Malaysia has created a number of ongoing issues, particularly in the areas of Islamic financial contracts, legal and regulatory requirements, risk management, accounting, and corporate and Shariah governance issues. In this respect, IFIs have to face the challenging environment not only to provide higher returns for the stakeholders but also to incorporate Shariah principles in all aspects of the IFI's business operations. The higher demand from stakeholders for Islamic financial products and services shows higher consideration among the stakeholders on Shariah compliance. Hence, IFIs have higher accountability to ensure Shariah compliance in their operations, reporting,

business conduct, risk management and governance, as well as monitoring and oversight functions. As a consequence, objective assurance of Shariah compliance in these aspects is crucially important to enhance the confidence of stakeholders.

Over the last few decades, IFIs in Malaysia have been in high demand by the stakeholders and heavily regulated by BNM as the regulator. The issuance of the SGF (2010) and Islamic Financial Services Act (IFSA, 2013) has revealed tremendous support and monitoring by the regulator to uphold the Shariah compliance matters and ensure effective Shariah governance is being implemented in the IFIs. Higher integrity and transparency must be visualised by the IFIs to show that they have established an effective Shariah governance mechanism through the internal Shariah audit function to achieve the objective assurance of Shariah compliance. Without an effective internal Shariah audit function, the integrity of IFIs will be questioned and the confidence of stakeholders will be undermined.

A review of ordinary conceptual studies in IFIs has highlighted the prevailing issues of Shariah governance and Shariah audit. In this respect, IFIs normally fail, not because of offering Shariah non-compliance products and services but because of bad governance and the lack of risk management (Askari, Iqbal, Krichene, & Mirakhor, 2011). Such issues could lead to Shariah non-compliance risks, which then affect the integrity of IFIs. The importance of Shariah compliance has raised the need for an effective internal Shariah audit function to be established within the IFIs to provide the objective assurance of Shariah compliance.

After the issuance of the SGF (2010), empirical studies on Shariah audit have emphasised various level of the Shariah audit practices in different types of IFIs in Malaysia. The majority of IFIs have implemented an acceptable level of Shariah audit practices using either a modified internal audit framework to accommodate Shariah

compliance or a self-developed Shariah audit framework (Ab Ghani & Abdul Rahman, 2015; Kasim, Mohamad Ibrahim, & Sulaiman, 2009; Yahya & Mahzan, 2012). Based on the empirical studies, it is emphasised that IFIs still face the issues of the scope of the Shariah audit, the lack of a Shariah audit charter, and the lack of internal Shariah auditors with adequate knowledge in Shariah (Ab Ghani & Abdul Rahman, 2015). These Shariah audit issues are more critical in the Islamic subsidiaries of conventional banks that operate both conventional and Islamic financial services. It is argued that the majority of IFIs have not established a dedicated Shariah audit function within the internal audit division (Yahya & Mahzan, 2012; Yussof, 2013). Hence, an effective internal Shariah audit function can be questioned.

Despite these critical and important issues of Shariah audit practices, no past empirical studies found on the effectiveness of the internal Shariah audit function in IFIs in Malaysia. This has raised concern about the extent to which IFIs have established better management of Shariah non-compliance risks in its Islamic business operations and whether the internal Shariah audit function is conducted by a competent internal Shariah auditor in the IFIs. Having an effective internal Shariah audit function is not just about establishing the Shariah audit function within the internal audit division in IFIs. In a highly regulated Islamic finance industry in Malaysia, all IFIs have statutory duty to comply with the minimum requirements to establish the Shariah audit function and other Shariah compliance functions as required in IFSA (2013). The establishment of the internal Shariah audit function is required as the means to obtain objective assurance of Shariah compliance in the IFI's business operations. In this respect, IFIs have the accountability to the institutional shareholders and other stakeholders. If stakeholders do not know the extent of the effectiveness of the internal Shariah audit function, this could indicate that one of the important functions of Shariah compliance