

Role of Internal Shariah Audit to Detect Non-Shariah Compliance

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ABSTRACT

The internal Shariah audit has emerged as an important means of ensuring that Islamic Financial Institutions (IFIs) act in accordance with the principles of Shariah. Thus, this paper explores the pivotal role of internal Shariah audits in identifying non-Shariah compliance within the IFIs. While the Islamic finance industry continues to expand and diversify, weaknesses in compliance with Shariah standards remain significant concerns as they may erode the confidence of stakeholders and challenge the legitimacy of the industry. This research is therefore informed by the need to improve the efficiency of internal Shariah audits in averting compliance related risks and encouraging sound governance within IFIs. Consequently, this paper focuses on the methodologies and practices of internal Shariah auditors to determine the existing flaws and develop recommendations for enhancing the current audit approaches. The analysis is based on the assessment of the current state of internal Shariah audit practices, key problems observed by the auditors, and suggestions for improving the compliance assurance level. These findings are expected to facilitate the improvement of internal Shariah audit in IFIs and thus help enhance the confidence in the Shariah compliance of these institutions.

Keywords: shariah, risk compliance, Malaysia

INTRODUCTION

Shariah audit is an integral component of Islamic financial organisations aimed at assessing compliance of organisational activities, financial products, and services with Shariah. This specialised audit process involves the systematic examination of financial activities and transactions to ensure compliance with the principles and regulation of Islamic jurisprudence. The Shariah audit involves a number of areas of contracts, financial activities and business conduct to determine their conformity with Islamic code of ethics. From this perspective, the main issue that we focussed on is associated with the identification of non-Shariah compliant matters in IFIs and other organisations that operate based on Islamic principles using the internal Shariah audit concept. It is to keep finance and operation processes strained by Shariah law that regulates some aspects of finance and business morality according to Islamic religion.

We need to focus more on this issue as to ensure compliance with Shariah law is essential for maintaining the trust and confidence of stakeholders, including customers, investors, and regulators. For customers, the compliance of the products and services they use with Shariah laws strengthens customer loyalty and satisfaction because they will be confident that the products and services they are using are right in the context of their religion and ethic. To investors, it provides an assurance that their investment funds are appropriate to invest and do business since the institution that receives their investment is highly stable. In this context, regulators consider the Shariah compliance as the level of conformance of the institution to the Islamic law regulating the practice of Islamic finance to ensure compliance with the legal and ethical requirements of the Shariah governance.

In addition, maintaining market integrity in the growing global Islamic finance sector is vital, as it preserves the authenticity of Islamic financial products and services, thereby fostering market growth and stability. Effective internal Shariah auditing enhances corporate governance by providing independent assurance that the

organisation adheres to Shariah principles, supporting better decision-making and risk management. Moreover, Shariah audits, similar to conventional audits, aim to prevent and detect fraud, mismanagement, and unethical practices, ensuring that operations align with Islamic ethical principles.

Along with the issue, we have found many previous studies that explain this Shariah audit. For example, Shafi et al. (2018) explain on exploration of the framework for Shariah governance and the function of Shariah audit in Islamic financial institutions. Research of Hasan (2011) discussed how well Shariah governance systems work in IFIs and stressed how important Shariah auditors are to making sure compliance and taking stakeholder complaints seriously. On the other hand, Rahman and Rahim (2010) investigated the Shariah auditing procedures in Malaysian IFIs and noted the difficulties Shariah auditors have, such as a lack of experience and standardisation. Noordin et al. (2014) examined the application of Shariah audit procedures in Islamic banks and suggested a comprehensive framework for Shariah audits to improve efficiency and dependability.

Shariah audit functions are led by the frameworks and standards which are established, such as those provided by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB). In audit planning and execution scope, internal Shariah auditors initiate audit plans. They include all the projects they are working on and also state the scopes, aim, and methodological approach they will use to comply with the Shariah principles. For risk assessments, a detailed description of the operational, financial, and reputational risks, non-compliance related to Shariah are taken into consideration by the Shariah auditors. Implementation in reporting and recommendation demonstrate that upon the finish of the audit. Shariah auditors make the whole process easier by preparing the much comprehensive reports that cover being fine, areas of non-compliance, and the corrective actions needed until the time of submission to the Shariah Supervisory Board (SSB) and senior management.

BACKGROUND OF STUDY

The internal audit function of IFI is credited for the introduction of the Shariah audit practice in Malaysia. We chose Malaysia for our research so that there is no compromise on shariah audit compliance in Islamic Financial Institutions (IFIs) such as Islamic banks (IBs) so that it follows Maqasid Shariah and there would be no possibility of noncompliance with shariah laws (Shehu et al., n. d.). The other reason for choosing Malaysia is that the shariah audit has not been fully successful, because of various challenges that have cropped up during implementation. Among the issues that it is found to be hard to manage is the general unfamiliarity with the concept of shariah audit especially from those working within the internal audit team (Ghani et al., 2022).

The matter becomes crucial as internal audit entails independent, objective assurance and consulting activity designed to add value and improve the organisation's operations (IIA, 2022). Moreover, internal audit assists organizations in achieving their objectives through the systematic approach to evaluate and improve the effectiveness of tools for managing risks, monitoring, and controlling the organization's activities. Apart from that, internal audit has the great responsibility to ensure that all the activities, services and products offered in Shariah compliant organizations are compliant with Shariah rules and Regulations. This entails several activities such as checking the legal compliance of financial transactions based on Islamic law and ensuring that other ethical standards such as prohibitions against usury (riba) and folly goods (gharar) are not violated (Khalid, 2020).

Shariah internal audit in Malaysia is still with many downsides and challenges, such as lacking of scope in the Shariah audit, inexperienced disqualified in both financial and Shariah expertise, not sufficient training, experience, knowledge, education, and professional ability (Nur Haryani Zakaria et al., 2019). Therefore, it is a general observation that many of the auditors in Malaysia do not possess enough skill and professional competency to qualify performing Shariah compliant audit, thus hampering the productivity and reliability of the Shariah internal audit process in Malaysia.

In Malaysia, Islamic Financial Institutions including the banks, perform audits in accordance with Shariah or not. According to the Shariah guidelines, it is pivotal for the internal auditors to adhere to the shariah in a bid to avert such risks like fraud. Shariah auditing also offers stakeholders additional information about the

amounts being presented in the financial statements and the extent of the company's compliance with shariah standards, which is also important (Abdul Rahman, 2011). Thus, in the long run, it may bring many benefits in the specific field of shariah auditing, help set up higher levels of globalization and standardization of the industry, as well as strengthen Malaysia's position in the international market of Islamic finance.

Problem Statement

This concerning the issue of shariah audit is about determining the non-shariah compliance and the specific internal shariah audit has rights into this. The need to have internal shariah audit is important because if a weak internal shariah audit is conducted then the external one will also not be good thus internal shariah audit must be strong. But the problem that arises is that out of the internal shariah audits some of them know the meaning of shariah but are clueless on how to adopt it into the shariah audit. It is a suggestion that auditors should enhance their knowledge of Shariah principles as well as financial processes in a bid to be in a position to notice violations of Shariah (Algabry et al., 2020).

The main issue that arises in this context relates to the fact that while most of the Shariah auditors are formally educated and thus have plenty of theoretical knowledge of what Shariah entails, they may be ineffective or have no practical experience in the ways of applying these rules in the audit. An imperfection between the theory and the practice hinders audit and leads to the failure to notice non-compliant activities, while making the compliance system irrelevant (Laili et al., 2022).

Factors that cause the internal Shariah audit to be ineffective are inadequate knowledge in operational Shariah issues, lack of guidance and support from superiors, inadequate training programs related to internal Shariah audit, inadequate in performing risk-based Shariah audit, difficulties in identifying the Shariah internal audit scope and inadequate implementation of risk-based Shariah internal audit (Rosli Abdul Aziz et al., 2019).

This entails that a weak internal Shariah audit has significant consequences. Not only does it hamper the capability of the institution in sustaining the adherence to Shariah standards, it also affects the reliability of the external Shariah audits. The work of external auditors heavily relies on the internal auditors to give a basic assessment of compliance. Internal audits that are insufficient, substandard or challenging, may compel external auditors to encounter problems in securing relevant and comprehensive information, may affect the means by which they can be conclusive in their audit (Shehu et al., 2020).

The Gap in Research

Several past related studies are found to evaluate the overall governance and compliance in IFIs while there is a lack of research on the practical working of internal Shariah auditors and the techniques used by them. For example, Abdullah and Rahman (2017) mainly focus their evaluation on Shariah boards and total governance structures. This study, however, will look at the comprehensive filing formations of the internal Shariah audit mechanisms. It will describe the manner in which auditors identify noncompliance, instruments like risk assessment checklists and audit checklists, and compliance testing approaches. Thus, this research will contribute to the literature by providing an understanding of the mechanisms at the operational level of the organization that guarantees Shariah compliance.

This research shall directly compare internal Shariah audit practices between different IFIs irrespective of the size and geographical location of the IFIs. Most of the existing research, for example the study by Hasan (2018), concentrates on individual universities or certain geographical locations without the bigger picture. While at the same time making comparative analysis of the relevant IFIs, this study will be able to discern optimal practices, widespread difficulties and the differences in the regional approaches to audits. This paper will thus engage in a comparison of all these firms with the aim of deepening the understanding of what constitutes best practice in Shariah auditing and reveal best practices that can be adapted or transferred across the industry.

The result of this research will be highly useful to the Islamic financial institutions due to its relevance. Therefore, IFIs' Shariah compliance is likely to improve when they uncover suitable audit mechanisms and integration approaches, which ultimately improves their credibility in the eyes of relevant stakeholders.

Altogether, this research will produce best practices for enhancing the internal auditing that can be implemented immediately. For example, it will propose the particular audit approaches, the training for the auditors, and the ways of improvement of the relation with the traditional audits. Duly, these practical tips will go a long way in assisting IFIs to improve on the ways and manners of conducting audits and achieving low incidences of non-compliance so as to boost on their governance and operations.

LITERATURE REVIEW

Many studies have focused on the ability of internal Shariah audit (ISA) in identifying non-Shariah compliance since the topic is very relevant in the contemporary world considering the rapidly rising use of Islamic finance. Non-Shariah compliance affects the Islamic financial institutions in a very dangerous manner because it brings into the market products that are questionable and are not long-term sustainable. This literature review seeks to assess the correlation between the level of internal Shariah audit (Independent Variable, IV) and the identification of non-Shariah compliant practices (Dependent Variable, DV), from the stated research works in the last five years.

Non-Shariah compliance is any trade or undertaking that makes violation of the principles of Shariah law that is used in Islamic finance. It is also important because any failure in this regard is costly in legal, reputation and financial terms, therefore it is important for IFIs to ensure compliance with Shariah. Current research focuses on effective early detection techniques that have measures to prevent non-Shariah compliance. Internal Shariah Audit (ISA) is the assessment of financial operations as an organised process and their compliance with the Shariah. ISA is a very important part of the governance structure of the IFIs which has the primary goal of addressing the compliance problems before they happen.

This paper looks at the research done by Aziz et al. (2020) which indicated that the results of ISA are outstanding in enhancing the discovery of the non-Shariah compliant nature of IFIs. The researchers underlined that apart from pointing out the cases of compliance breaches, ISA also offers suggestions for compliance deficiencies' remedial measures; thus, strengthening the compliance system of IFIs as a whole. Another study by Hassan and Yusof (2021) also suggests that internal Shariah auditors have a critical duty of performing risk management by evaluating the Shariah compliance of the financial products and transactions. The study also revealed that proper and effective ISA activities indicated that less number of non-Shariah compliances are possible, thus, there is less operation risk to the IFIs. In their study, Ibrahim et al. (2022) identified the training and competency of Shariah auditors as a critical aspect in identifying non-compliance. The research revealed that concern internal Shariah auditors' behaviour and skill, it was also ascertained that; There is sensitive positive relationship between level of expertise of internal Shariah audit and auditors ability to identify non-Shariah compliant activities.

Similarly, the scholars' research record underscores and refers to the positive correlation between internal Shariah audit and identifying non-Shariah compliance. In its turn, the efficiency of these procedures, which require competent auditors, independence, and, most importantly, technological literacy, is critical for ensuring the Shariah compliance of IFIs' operations. The future studies should bring out these dynamics in greater detail, as to unravel the ways in which new trends in audit practice and technology could improve the sector's mechanisms of compliance.

The Proposed Conceptual Framework

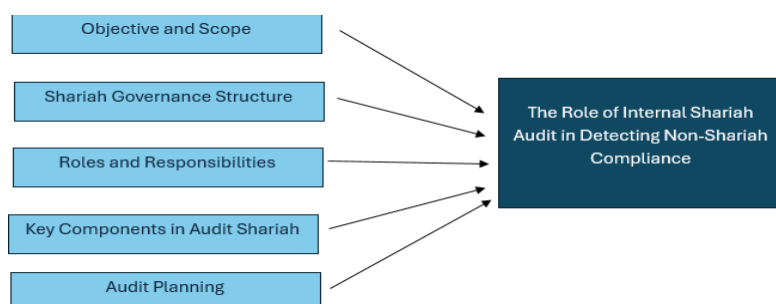


Illustration 1: The proposed conceptual framework for the role of internal Shariah audit in detecting non-

Shariah compliance

CONCLUSION

The conceptual framework proposed in this study for the role of internal Shariah auditing in non-Shariah compliance detection, therefore, provides the all-inclusive approach in ensuring that there is strict adherence to Shariah principles by the Islamic financial institutions. This second framework explains the important role of internal Shariah audits in protecting the integrity and authenticity of Islamic finance operations.

The framework brings out several key components which is firstly, internal shariah auditing helps to identify and assess areas of probable non-compliance, which enables the proactive management of risks arising out of non-adherence to Shariah. Continuous monitoring and evaluation processes associated with financial activities ensure that proceedings are based on Shariah principles, thus promoting trust and confidence of the related stakeholders.

Other than that, continuous education and training of audit personnel in Shariah laws enhance their capability, hence improving the effectiveness of audits and ensuring that all aspects of operations have been taken under close scrutiny. By making shariah audits an integral part of the corporate governance framework will ensure that Shariah compliance is not recognized as a standalone operation but is justifiably viewed as part and parcel of the institution's ethical and operation norms. Also by engaging with stakeholders, including Shariah scholars, regulatory bodies, and the community, enhances transparency and accountability, promoting a culture of compliance and ethical behaviour.

If adopted, the framework may result in immense development in areas such as detection and prevention of non-Shariah compliance activities. It enhances the credibility of Islamic financial institutions by providing investors, customers, and the Islamic community worldwide with the assurance to be able to rely on them. To boot, it also contributes to developing a robust regulatory environment that would underpin the sustainable growth of the Islamic finance industry.

Future studies should be aimed at the empirical validation of the suggested framework through case studies and its practical application in various Islamic financial institutions. Further research in the exploitation of the latest technological developments in the field of artificial intelligence and blockchain can be carried out to further increase the effectiveness of internal Shariah audits.

The role of internal Shariah audits comes to the fore in relation to the observance of ethical standards and principles of Islamic finance. This conceptual framework acts as the mainstay guide in such a manner that it will, therefore, aid such institutions in striving to attain, and hence maintaining, Shariah compliance in support of the integrity and growth of the Islamic finance sector.

RECOMMENDATION

From our analysis, we can provide a few recommendations to improve the role of internal audit shariah. First, it is important to strengthen risk assessment processes. We can strengthen risk assessment processes by changing into comprehensive risk assessment tools that would suit best the unique needs of the Islamic financial institutions. For example, by conducting regular risk profiling for potential areas of non-compliance with customs legislation, targeting high-risk activities and transactions.

Second is by implementing continuous monitoring and evaluation. It can be done by installing permanent monitoring systems to ensure continuous compliance with the principles of Islamic law. For example, by identifying the ability to leverage data analytics and real-time monitoring tools, such anomalies or non-compliance activities at the earliest opportunity. It shall, therefore, invest in specialised training programs for internal auditors to gain better knowledge about Shariah laws and financial principles.

Third, institutions can integrate monitoring and risk assessment tools into Shariah audits by adapting specific processes and frameworks to ensure Shariah compliance while also addressing unique risks associated with

Islamic financial practices. Consistently with the suggestion, the development of a shariah governance policy is best integrated between monitoring and risk assessment. Institutions should have clear policies outlining the roles of Shariah committees, compliance officers, and internal auditors

The last recommendation is to conduct regular internal and external audits. It follows that periodic internal and external Shariah audits must be undertaken as a matter of course to ensure compliance and to highlight room for improvement. These audits shall use findings in the further fining and improvement of internal audit processes.

These recommendations would go a long way in extending powers of internal Shariah audits necessitated with monitoring compliance and ensuring that accredited Islamic financial institutions are run stringently based on the Shariah concept. With this, such institutions should be able to cultivate high confidence amongst the stakeholders by entrenching a strong culture of compliance and embracing the latest technological innovation to foster sustainable growth marked with integrity in the Islamic finance industry.

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