

Internal Shariah Audit Effectiveness and its Determinants: Case of Islamic Financial Institutions in Malaysia

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I. Introduction

Bank Negara Malaysia (BNM) has made it compulsory in its Shariah Governance Framework (SGF) for Islamic Financial Institutions (IFIs) to implement Shariah audit as one of the Shariah compliance mechanisms (Bank Negara Malaysia, 2010). This requirement is further reinforced with the issuance of a revised Shariah governance Exposure Draft issued in December 2017 with similar emphasis on the implementation of internal Shariah audit (ISA) in IFIs to provide assurance on Shariah compliance. However, this exposure draft has yet to be made effective by Bank Negara Malaysia.

In the earlier SGF 2010, IFIs are required to either have in-house ISA team/department/unit and can outsource this role to consultancy firms. Either way, ISA must be implemented as one of the Shariah compliance function as stipulated in the SGF. The function of ISA is to complement other Shariah compliance functions such as Shariah Review, Shariah Research and Shariah Risk Management. ISA practice assist the Shariah Committee providing an independent assurance that operations of IFIs are Shariah compliant. Such a requirement is timely as the Islamic banking assets and takaful operators' net contribution has shown tremendous increase over the past couple of years. For instance, in year 2013, the Islamic banking assets in Malaysia amounted to USD140 billion and it is expected to increase to more than USD392 billion by year 2018 with compounded annual growth rate of 21 percent (Ernst & Young, 2013). As for the takaful industry, the gross takaful contributions have grown to USD2.7 billion in year 2014 (Bank Negara Malaysia, 2014).

Additionally in year 2013, Malaysia has issued the Islamic Financial Services Act (IFSA) 2013 that calls for greater effort by the Islamic financial services industry to promote financial stability and Shariah compliance. Section 28(5) of this Act states that if IFIs are in breach of Shariah compliance, any person responsible will be liable for eight years of imprisonment or penalty amounting to RM25 million if IFIs do not take proactive action to rectify and inform BNM in stipulated time. Therefore, the internal audit on Shariah compliance must be effective enough to strategically monitor and prevent the IFIs' operations from breaching Shariah principles.

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There have been cases of failure of IFIs to ensure compliance with stakeholders' religious beliefs like the case of Bank of Credit and Commerce International (BCCI). The case involved five IFIs that deposited significant resources with BCCI with the understanding that they would be invested in commodity contracts in compliance with Shariah principles but were later found out otherwise by BCCI's external auditor (Graiss and Pellegrini, 2006).¹ The size of the exposure suggests a weak due diligence process in the verification of Shariah compliance and illustrates the limits of Shariah Committee members may face in discharging its duties. Even for institution that proclaims itself, as Shariah compliance is not immune from the mismanagement scandals as ethical business can be seen as part of the bigger picture of Shariah compliant. The collapse of Ihlal Finance House (IFH) of Turkey in 2001 provides an example how weakness in internal and external checks and balance results in misappropriation of funds that the bank was unable to pay back its depositors upon liquidation (Starr and Yilmaz, 2007). The establishment of an effective ISA will acts as the third level of defense in the IFIs' risk management mechanism to prevent IFIs from suffering failures in adhering to Shariah principles (Mohd Hanefah, Shafii, Salleh and Zakaria, 2012).

This conceptual paper investigates the concept of internal Shariah audit effectiveness (ISAE) and its possible determinants by reviewing regulations (i.e. internal auditing framework and the SGF) and past literature in internal audit effectiveness (IAE) and ISA in IFIs.

II. Internal Shariah Audit Effectiveness

BNM in its SGF mentioned that ISA to be performed by the internal audit department. The relevant auditing standards are International Professional Practices Framework (IPPF) and the International Standards Professional Practice of Internal Auditing (ISPPA). These standards are issued by the by the Institute of Internal Auditors (IIA). The IPPF in its Practice Guide on Measuring Internal Audit Effectiveness and Efficiency defined internal audit effectiveness as *"the degree (including quality) to which established objectives are achieved"* (Institute of Internal Auditors, 2010).

Dittenhofer (2001) also defined effectiveness as the achievement of goals and objectives using the factor measures provided for determining such achievement. He further elaborated that the determination of effectiveness is evaluated on the quality of internal auditing procedures. Beckmerhagen, Berg, Karapetrovic and Willborn (2004) mentioned that in order to adequately measure audit effectiveness, evaluation must not be done only on results of the audit against the planned objectives, but also the audit process (planning, execution to

¹ The IFIs are Faisal Islamic Bank of Egypt, the Dubai Islamic Bank, the Khartoum-based Tadamon Islamic Bank, the Qatar Islamic Bank and Kuwait Finance House. This is as reported by the *Asian Wall Street Journal: BCCI Creditors Granted More Time*, April, 1992.

reporting and follow-up) and resources (auditor independence and competence).

Albrecht, Howe, Schueler and Stocks (1988) found that internal audit is effective when their work or output is consistent with the objectives and role determined by top management and the audit committee. They concluded that audit effectiveness could be achieved when there is clear understanding of both the roles and benefits expected of internal auditing by all involved parties. Therefore, it is imperative for institutions to have a clear set of objectives and roles communicated by top management and audit committee for internal auditors to achieve.

In the case of ISA, the regulator has provided its objective in the BNM's SGF, which is to ensure "*a sound and effective internal control system is in place for Shariah compliance*" (Bank Negara Malaysia, 2010: Paragraph 7.7). Thus, within this context, Shariah audit can be considered effective when it is able to identify weaknesses in internal control activities and potential risks that might affect IFIs' commitment to Shariah compliance. Only then, Shariah auditors would be able to provide useful recommendations so management can improve their internal controls for Shariah compliance.

However, prior literature published before the issuance of BNM's SGF showed various authors proposing the objective of Shariah audit should be much broader and general. They believed that Shariah audit should ensure activities carried out by IFI do not contravene Shariah, which may include auditing the financial statements, operational activities, organisational structures, policies and procedures, documentations and contracts as well as socio-economic, religious and environmental actions (Mohamed Sultan, 2007; Abdul Rahman 2008; Mohamed Ibrahim, 2008). Even Khan (1985) highlighted that the scope of auditing in Islamic framework is much larger to also include assessment and report on various social and economic aspects of business organization. It is important to note that the discussion by Khan (1985) on the role of Shariah auditor however, was directed for external Shariah audit by comparing it to the conventional external audit practice (i.e attesting on accuracy of accounts, providing assurance on the true and fair view of the financial statements).

It seemed that this point of view is still relevant even after the issuance of BNM's SGF. A conceptual paper published in year 2013 by Yussof argued the ideal objective of Shariah audit should not be merely assessing on legal/technical form of business transactions but to be more balanced, integrated and holistic focus to include technical, ethical and *maqasid*-based audit. She suggested that IFIs should develop a Shariah-specific Audit Charter to reflect the IFIs' commitment for company-wide Shariah compliance. Having an audit charter would also reflect that there is an agreed objectives that Shariah audit is supposed to achieve because according to the ISPPIA, an audit charter is a formal document that is approved by the Senior management and the Board. It should contain information about the internal audit activity's purpose, authority and responsibility.

An empirical study conducted after the issuance of BNM's SGF by Yahya and Mahzan (2012) found practitioners agreeing with the definition and objective of Shariah audit stipulated by BNM's SGF. They conducted in depth interviews with five individuals from five IFIs that were involved in Shariah audit. All agreed that the definition and practices of Shariah audit is similar to conventional internal auditing except that Shariah audit has a unique objective of ensuring a sound and effective internal control for Shariah compliance. The respondents' internal audit department even referred to the IIA's IPPF and ISPPA as well as BNM's Guideline on Minimum Audit Standards for Internal Auditor of Financial Institution.² Nonetheless, respondents believed that BNM should at least issue a general framework and general list of audit program to be used as a guideline for the IFIs. Currently, the respondents used conventional audit program with some modification to suit Islamic banking products and operations.

Even the determination of Shariah audit objectives has raised various opinions. The actual internal Shariah audit practices in the industry are not without challenges and problems. Empirical studies found that there is shortage of auditors with knowledge of both Shariah and accounting / auditing knowledge, narrow scope of audit coverage, the need for Shariah audit certification and professional qualification, the need for standardization of Shariah audit framework, issue on independence and self-review threat (Kasim and Sanusi, 2013; Kasim, Sanusi, Mutaminah and Handoyo, 2013; Yussof, 2013; Shafii, Salleh, Mohd Hanefah, and Jusoff, 2013; Yaacob, 2012; Yahya and Mahzan, 2012; Abdul Rahman, 2008; Kasim, Mohamed Ibrahim and Sulaiman, 2009; Mohamed Ibrahim, 2008).

The problems faced in the industry are very much expected because there is no standard Shariah-specific internal audit framework. As a result, the current audit practice is not uniformly performed and some even seems to replicate external auditing, which is restrictively focusing on financial audit (Yussof, 2013). The current SGF by BNM is principle-based guidelines with minimum prescriptions on internal Shariah audit practices. This is because the BNM's SGF is tailored for Shariah governance and Shariah audit is only one of the Shariah compliance function necessary for overall functioning of the Shariah governance in IFIs.

At the international level, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued specific auditing standards for both internal and external Shariah audit. However, AAOIFI's standards are not compulsory for IFIs in Malaysia to adopt and the BNM's SGF is at current considered mandatory. Kasim and Sanusi (2013) nonetheless found that IFIs do refer to AAOIFI's auditing standards in addition to local auditing standards. AAOIFI's standards relatively give a more detailed guidance compared to the BNM's SGF.

A comparative review of important aspects of internal Shariah audit by BNM's SGF,

² This guideline is not Shariah-specific standard for Shariah auditing, but a general guideline for internal audit for both conventional and Islamic financial institutions in Malaysia.

Internal Shariah Review (similar to internal audit) by AAOIFI and internal auditing by the IIA's ISPPA was performed in Table 1. From the review, AAOIFI and ISPPA do provide a more detailed and specific guidance on how internal audit should be performed, in terms management of the internal audit function, its performance and quality assessment review. However, the BNM's SGF gives a brief account of Shariah audit's definition, line of reporting and its work performance.

Table 1: Comparison of Regulatory Framework for Internal Shariah Audit and International Standards for Internal Auditing

Areas	BNM's SGF	AAOIFI (Internal Shariah Review ³)	ISPPA (Internal Auditing)
Objective	Paragraph 7.7: <i>"... to provide an independent assessment and objective assurance to ensure a sound and effective internal control system for Shariah compliance."</i>	Paragraph 2: <i>"... to ensure that the management of IFIs discharge their responsibilities in implementing Shariah rules and principles as determined by IFI's SSB."</i>	Definition of internal auditing by IPPF: <i>"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."</i>
Scope	Paragraph 7.12: <i>"... all aspects of the IFI's business operations and activities, including: a. audit of financial statements b. compliance audit on organizational structure, people and IT application systems; and c. review of adequacy of the Shariah governance process"</i>	Paragraph 17: <i>Examination and evaluation of the adequacy and effectiveness of the IFIs' system of internal Shariah control and the quality of performance in carrying out assigned responsibilities.</i>	Performance Standard 2100: Nature of Work <i>Internal audit activity must evaluate and contribute to the improvement of governance, risk management and control processes using a systematic and disciplined approach.</i> (More elaboration on each component of internal auditor's Nature of work is provided in 2110: Governance; 2120 Risk Management; and 2130: Control)

3 Governance Standard for Islamic Financial Institutions No. 3: Internal Shariah Review (AAOIFI, 2010)

Scope			Performance Standards 2220 Engagement Scope: "... relevant systems, records, personnel and physical properties..."
Process	Paragraph 7.13: a. <i>Understand the business activities of the IFI – to allow for better scoping of an audit exercise</i> b. <i>Develop a comprehensive internal audit program</i> c. <i>Obtain and make reference to relevant sources (e.g. Shariah Advisory Council's published rulings, the Shariah Committee's decisions etc)</i> d. <i>Conduct Shariah audit on a periodical basis</i> e. <i>Communicate results or findings to the Board Audit Committee and the Shariah Committee; and</i> f. <i>Provide recommendations on rectification measures taken as well as following-up on the implementation by the IFI.</i>	Paragraph 18–22: a. <i>Planning which involve understanding business activities, determining resources required to perform the review, establish objectives and scope of work, preparing Shariah review programs, etc.</i> b. <i>Examine and evaluate information to support the internal Shariah review results. This involves examination of documentation, analytical reviews, inquiries, discussions with management and observations. All these need to be documented in working papers.</i> c. <i>Quarterly report be prepared by the Head of internal Shariah review submitted to the Board of Directors and copied to the Shariah Supervisory Board and management.</i> d. <i>Perform follow up to ascertain that actions have been taken on their reported internal Shariah review findings.</i>	Performance Standard The following standards covered audit process performed at the engagement level. 2200 <i>Develop and document an audit plan that includes objectives, scope and timing</i> 2240 <i>Develop and document work program (this is similar to audit program that has procedures to identify, evaluate and document information during engagement)</i> 2300 <i>Performing the engagement by identifying, analyzing, evaluating and documenting sufficient information to achieve engagement objectives.</i> 2400 <i>Internal auditors communicate the results of engagements. This includes objectives, scope, conclusions, recommendations and action plans.</i> 2500 <i>Chief audit executive establish a follow-up process to monitor and ensure that management actions have been implemented or senior management has accepted the risk of not taking action.</i>

Independence and objectivity	Paragraph 1.6: <i>Audit findings reported to Board Audit Committee and Shariah Committee.</i> Comment: This establishes formal line of reporting between Shariah audit and Board Audit Committee as well as the Shariah Committee. Paragraph 7.11: <i>Board Audit Committee upon consultation determines the deliverables of Shariah audit function. It must be consistent with accepted auditing standards.</i> Comment: The SGF did not define what they mean by deliverables. Nonetheless, it is safe to assume that the relevant auditing standards would be related to internal auditing since Shariah audit function is to be performed by internal auditors.	Paragraph 6–8: a. <i>Organizational status not lower than internal audit department.</i> b. <i>Have direct and regular communications with all levels of management, SSB and external auditors.</i> c. <i>Shall have access to all documents, reports, etc.</i> d. <i>Head of Internal Shariah Review be responsible to the Board of Directors.</i> e. <i>Head shall ensure full shariah review coverage, adequate consideration of the Internal Shariah Review reports, an action on the review recommendations.</i>	Attribute Standards 1100: <i>Chief audit executive has direct and unrestricted access to senior management and the board.</i> 1110: <i>Chief audit executive reports functionally to the Board.</i> 1111: <i>Chief audit executive must communicate and interact directly with the Board.</i>
Competency requirement	Paragraph 7.8: <i>Internal auditors who have acquired Shariah-related knowledge and training.</i> Comment: The SGF however did not specifically mention what type of Shariah related knowledge. It can be inferred from the criteria set for Shariah Committee and Shariah Review that the knowledge is fiqh muamalat and usul-fiqh.	Paragraph 12: <i>Knowledge in Islamic Shariah rules and principles in general, and fiqh muamalat in particular.</i>	Attribute Standards 1210: <i>Internal auditors must possess the knowledge, skills and other competencies needed to perform their individual responsibilities.</i>

Audit approach	Paragraph 7.10: <i>Audit conducted according to risk level and materiality of the impact of Shariah non-compliance.</i> <i>Audit on critical areas conducted at least once a year depending on risk profile of the IFI.</i> Comment: It is implied that Shariah audit need to have information on the risk profile of IFIs business operations, which means that IFI should have in place risk management framework for managing Shariah non-compliance.	Comment: The standard did not specifically mention what audit approach were to be used.	Attribute Standards 1220.A3: <i>Internal auditors must be alert to the significant risks that might affect objectives, operations, or resources.</i> Performance Standard 2010: Planning <i>Chief audit executive must establish a risk-based plan to determine priorities of internal audit activity.</i>
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Source: Bank Negara Malaysia (2010), Institute of Internal Auditors (2012) and AAOIFI (2010)

Based on the above review, a more detailed framework outlining the audit environment, audit input, process and output for effective ISA practice is needed in the Malaysian context. The criteria for effectiveness are also needed as guidance for Shariah auditors to perform their job better.

Since there is limited empirical study on ISAE in IFIs in Malaysia, the paper refers to mainstream research on IAE for guidance and modification of criteria as necessary to suit the unique operations of IFIs in light of the BNM's SGF and IFSA 2013's requirements.

Prior studies on internal audit effectiveness suggested various methods of defining and measuring internal audit effectiveness, either from the perspective of the internal auditors themselves or stakeholders of internal audit practice (Lenz and Hahn, 2015). The authors agreed that internal audit effectiveness is contextually bound because internal audit function may serve different purposes in their respective specific organizational context. Regardless of the various definitions it has, Lenz and Hahn (2015) suggested that the stakeholder view on effectiveness is regarded as valuable input to first measure and later improve on internal audit practice. Measurements of effectiveness can range from single-measured item to multi-dimensional aspect consisting of various items (Albrecht, Howe, Schueler and Stocks, 1988; Lampe and Sutton, 1994; Ziegenfuss, 2000a, 2000b; Mihret and Yismaw, 2007; Rupsys and Boguslauskas, 2007; Arena and Azzone, 2009; Alzeban and Gwilliam, 2014; Lenz and Hahn, 2015).

Multidimensional aspects usually consist of criteria of effectiveness for the audit environment, audit process, audit input, audit output, quality of internal audit function and audit outcome. Albrecht *et al.*, (1988) surveyed multi-stakeholder perspective on effectiveness and found 15 criteria that were classified as either qualitative, quantitative measures or feedback. Feedback is effectiveness as perceived by stakeholders such as the auditee, external auditor, top management, Audit committee, results of internal review and peer feedback. The top ranked criteria for effectiveness is reasonable and meaningful findings and recommendations. The researchers classified this as a qualitative measure because it involved a matter of judgment for the evaluator (CEO, CFO etc). Lampe and Sutton (1994) identified 15 audit quality factors that characterizes internal audit effectiveness and further sub-categorized in accordance to the audit process, that is planning, fieldwork, and reporting and review. This was developed based on interview from the internal audit group of six organizations.

Alzeban and Gwilliam (2014) also used multi-item measure for internal audit effectiveness. They measure internal audit effectiveness based on quality of the function as perceived by the managers of audited departments. Aspects of internal audit function that was evaluated include ability to plan, improvement of organisation's productivity, implementation of internal audit recommendations, evaluation and improvement of risk management, evaluation of internal control systems, and recommendations for improvement.

Ziegenfuss (2000b) and Cohen and Sayag (2010) both used 84 items from the 1997 IIA's Global Auditing Information Network (GAIN) questionnaires and modified to suit national internal auditing environment. Ziegenfuss (2000b) reclassify the 84 items into 16 performance measure areas and categorized it further into four audit process: audit environment, input, process and output. He found that survey results of auditee satisfaction and the percentage of recommendations that are implemented are the performance measures considered by the audit director to be most suitable to evaluate internal audit effectiveness. Cohen and Sayag (2010) had modified the GAIN 1997 survey items into 37 items. The reduction of items was based on interviews with business leaders, public sector leaders as well as comments from experts in internal auditing, academicians and practitioners. They found internal audit effectiveness consists of three dimensions that are audit quality, auditees' evaluations and added contribution of internal audit.

It is argued that ISAE should be analysed based on various aspect of the ISA practice. Mihret and Yismaw (2007) opined that internal audit effectiveness is a dynamic process and similar assumptions for ISAE is put forth. It is because, its extent of effectiveness cannot be measured by just looking at its ability to complete the annual audit plan, but depends on whether it is able to adequately audit comprehensive coverage of Shariah risk areas, identify weaknesses in internal control, instances of Shariah non-compliance events and risks, as well

as the overall functioning of Shariah governance. Shafii, Salleh and Zakaria (2014), based on a focus group interview, discovered the audit scope for audit of financial statements to include among others, sources of funding must be halal, zakat determination and reporting, calculation and reporting of ta'widh and early settlement, investment activities must be Shariah compliant as well. A single case study by analysis by Shafii, Zainal Abidin, Salleh, Jusoff and Kasim (2013) found that Shariah audit practice has an added value in ensuring Shariah compliance. Based on Shariah audit findings, Shariah auditors recommend proper internal control system that was later approved by the Shariah Committee for establishment and implementation in the said IFI.

In the BNM's SGF, ISA is one of the Shariah compliance functions that support the function of Shariah Committee and complements other functions such as Shariah Research, Shariah Review and Shariah Risk Management. Mohd Hanefah *et al.* (2012) mentioned the importance of Shariah audit as the third level of defense in mitigating Shariah non-compliance risk. Daugherty and Anderson (2012) also asserts an effective internal audit is often thought as the third line of defense in providing assurance on risk management process. Therefore, Shariah audit plays an important role in providing assurance that IFIs have effectively manage Shariah non-compliance risk and IFIs have implemented adequate internal control system for Shariah compliance.

Based on the BNM's SGF and arguments from prior studies, ISAE can be defined as the ability of the ISA function to provide assurance on Shariah compliance by assessing the effectiveness of internal control for Shariah compliance, Shariah risk management and overall Shariah governance. ISA assurance is given through quality audit report with audit recommendations that will be implemented by the auditee. Further, quality audit report is the outcome of comprehensive audit scope, testing and documentation.

III. Determinants of Internal Shariah Audit Effectiveness

Internal Shariah audit function requires support from top management and the Board in order to properly function as one of the key organs of the Shariah governance framework (Bank Negara Malaysia, 2010). In order to better understand the determinants of effectiveness, we look to prior empirical studies on internal audit effectiveness. Most of the studies were conducted in the area of public sectors, public listed entities and conventional banks (Mihret and Yismaw, 2007; Badara and Saidin, 2014a, 2014b; Ramachandran, Subramanian and Kisoka, 2012; Cohen and Sayag, 2010; Ahmad, Othman, Othman and Jusoff, 2009; Arena and Azzone, 2009; Alzeban and Sawan, 2013; Alzeban and Gwilliam, 2014). However, these studies found inconclusive results indicating various factors affecting internal audit effectiveness. In addition, the factors were also defined differently in different context of studies. The most commonly cited determinants were management support, characteristics

of internal audit team, audit processes and activities, organizational independence and professional proficiency of internal auditors. As such, this paper referred to both empirical findings, the BNM's SGF and ISPPIA to identify the most relevant determinants of SAE.

3.1. Top management support

BNM's SGF stresses the importance of management in providing resources and capable manpower in order for Shariah audit to be performed effectively (Bank Negara Malaysia, 2010). The infrastructure and resources should include budget allocation and trainings and development. Budget allocation for competent manpower is important because Shariah auditors need to be knowledgeable in Shariah related knowledge, such as fiqh muamalat as depicted in Table 1 above. Therefore, support from top management will provide sufficient resources to execute their duties and responsibilities, and the internal audit department can hire qualified staff and provide continuous training and development (Alzeban and Sawan, 2013; Cohen and Sayag, 2010). Continuous training and development is also crucial so that Shariah auditors would be exposed to current developments in Shariah related matters.

The ISPPIA also highlights the importance of relationship between senior management and internal auditing and how management can support internal auditing. The Chief audit executive should consider inputs from senior management when developing the internal audit plan (ISPPIA, Standard 2010.A1). Additionally, Chief audit executive must report on a periodic basis to senior management and the Board about the internal audit's purpose, authority, responsibility, and performance against its plan (ISPPIA, Standard 2060). As Alzeban and Gwilliam (2014) suggests, internal audit is required to provide senior management with sufficient, reliable and relevant reports about the work performed, conclusions reached and recommendations made. An indication of management support is how receptive management of the audit findings and their action to implement the recommendations provided by internal auditors (Mihret and Yismaw, 2007; Ahmad *et al.*, 2009).

Having management support also warrants resources being used by management for implementation of internal control for Shariah compliance (Shafii and Salleh, 2010; Badara and Saidin, 2014a). The BNM's SGF however, did not provide any definition and framework for internal control for Shariah compliance. Shafii and Salleh (2010) study was one of the first to discuss Shariah internal control system. They defined it as a combination of Shariah compliance with the five major components of internal control system as outlined by the Committee of Sponsoring Organisations (COSO) Framework.⁴ In other words, it is the

⁴ The COSO's Internal Control- Integrated Framework has five components, namely control environment, risk assessment, control activities, information and communication, and monitoring. For more information please visit the website www.coso.org.

integration of Shariah principles with the five major components of internal control.

The Basle Committee on Banking Supervision believes that internal control is a process effected by the board of directors, senior management and all levels of personnel.⁵ The board of directors and senior management are responsible for establishing the appropriate culture to facilitate an effective internal control process and for monitoring its effectiveness on an ongoing basis. One of the internal audit roles is to assure management and the Board that it is operating effectively. Badara and Saidin (2014a) found that effective internal control system put in place by management do contribute to internal audit effectiveness.

Prior studies found that support from management is critical to the success of internal audit function and lead to internal audit recommendations being implemented (Albrecht *et al.* 1988; Ahmad *et al.* 2009; Mihret and Yismaw, 2007; Cohen and Sayag, 2010; Alzeban and Gwilliam, 2014). Alzeban and Gwilliam (2014) found management support contributed the most to internal audit effectiveness. Mihret and Yismaw (2007) in their case study analysis found similar result, where management support is one of the two most important factors influencing internal audit effectiveness.

3.2. Organizational independence and objectivity

The organizational independence and objectivity of internal Shariah auditors is important for providing assurance on Shariah compliant. In Table 1 above, BNM's SGF requires Shariah audit to report to Board Audit Committee and Shariah Committee on their findings. Further, the Board Audit Committee with consultation from Shariah Committee will determine the deliverables of Shariah, which is annual audit plan and reports. The high level reporting indicates the importance of Shariah audit function has in the overall monitoring for Shariah compliance. The assurance on Shariah compliance is given high standings as findings and recommendations from Shariah audit is expected to help Board, Shariah Committee and management perform their duties. When the Board Audit Committee provides a platform for the internal audit function to present findings at their committee meetings, this sends a signal that the internal audit function is an important function within the organization (Soh and Martinove-Bennie, 2011).

From the BNM's SGF, Shariah audit is independent from management and operations as they report to a higher-level function, that is Board Audit Committee and Shariah Committee. Bou-Raad (2000) argued that the strength of an internal audit department must be assessed with respect to the level of independence it enjoys from management and from operating responsibilities. Attribute Standards of the ISPPA similarly suggest that appropriate independence can be gained by reporting to levels within the organization that

⁵ Basle Committee on Banking Supervision also developed a model of internal control for financial institution that was based on the COSO model.

allow internal audit to perform its responsibilities free from interference, having direct contact with the board and senior management, having unrestricted access to records, employees and departments.

Prior studies found that organizational independence is important for effective internal audit function (Cohen and Sayag, 2010; Alzeban and Gwilliam, 2014; Arena and Azzone, 2009; Soh and Martinov-Bennie, 2011). Majority of prior studies relating to the organizational status of internal audit have focused on internal audit's relationship with the Audit Committee (Stewart and Subramaniam, 2010). Mat Zain, Subramaniam and Goodwin-Stewart (2006) point out that audit committees could enhance internal audit effectiveness. Additionally, by reporting to and having frequent meetings with audit committee contribute to internal auditor's objectivity (Cohen, Krishnamoorthy and Wright, 2004; Goodwin and Yeo, 2001; Mat Zain and Subramaniam, 2007; Raghunandan and Mchugh, 1994; Mihret, James and Mula, 2010). Mat Zain *et al's* (2006) study also indicates that audit committees assist in enhancing management action on internal audit recommendations. Similarly, based on a study of Singaporean companies, Goodwin and Yeo (2001) suggest that internal audit interaction with audit committee enhances internal audit independence and objectivity. Internal auditor's objectivity is also enhanced when a board retains the authority to hire and fire the Chief Audit Executive (Raghunandan and Mchugh, 1994).

3.3. Internal Shariah audit process and activities

The ISA process and activities is similar to a conventional internal audit function. The main difference would be the audit scope and coverage focusing on the effectiveness of the overall internal control for Shariah compliance (Yahya and Mahzan, 2012). In specific, we have seen that Shariah audit need to cover among others audit of financial statements, compliance audit on organizational structure, people and IT application systems and review the adequacy of Shariah governance process (Bank Negara Malaysia, 2010). Nonetheless, overall Shariah audit process and activities were found to be similar to conventional internal audit practice as per ISPPA's Performance Standard ranging from 2200 until 2500 in Table 1 above.

ISA process and activities involves planning, fieldwork and communication of audit findings and recommendations and follow-up (Bank Negara Malaysia, 2010). Audit planning, fieldwork and effective communication do influence internal audit effectiveness and it serves as a proxy for internal audit quality (Mihret and Yismaw, 2007). When internal auditors properly plan, perform and communicate the result of audits, it will result in internal audit quality and thus, influence internal audit effectiveness.

Both the BNM's SGF and the ISPPA's standard highlighted the importance of conducting risk-based audit as shown in Table 1 above. ISPPA in Performance Standards 2010 emphasised the role of Chief Audit Executive in ensuring audit plan developed are

risk-based. Similarly, BNM's SGF require Shariah auditors to consider the risk level and materiality of the impact of Shariah non-compliance in areas audited.

Prior studies found that risk-based internal audit (RBIA) is important and auditors are expected to focus on critical risks and issues (Spira and Page, 2003; Allegrini and D'Onza, 2003; Sarens, Abdolmohammadi and Lenz, 2012; Ernst & Young, 2012; PWC, 2014; Lenz and Hahn, 2015). Most literature when referring to risk-based internal auditing would either mention the role of internal auditing in the overall risk management strategy or the internal audit function's plan will be based on the organisation's strategic (Coetzee and Lubbe, 2014). However, there is the issue of threats to independence and objectivity when internal auditors involved extensively in consulting management on risk management framework and its implementation (Zwaan, Stewart and Subramaniam, 2011). Internal auditors should be more focused on providing assurance to the effectiveness of the organization's risk management framework (Institute of Internal Auditors UK and Ireland, 2009; Sarens and De Beelde, 2006). There are studies that found internal audit function having an active role in corporate governance is significantly and positively associated with the use of risk-based audit plan, existence of quality assurance and improvement program, and audit committee input to the audit plan (Sarens *et al.*, 2012).

The Chartered Institute of Internal Auditors UK provides definition for RBIA that was used by prior researchers like Sarens *et al.* (2012). RBIA is defined as

a methodology that links internal auditing to an organisation's overall risk management framework. RBIA allows internal audit to provide assurance to the board that risk management processes are managing risks effectively, in relation to the risk appetite. (Chartered Institute of Internal Auditors UK, 2014: 1).

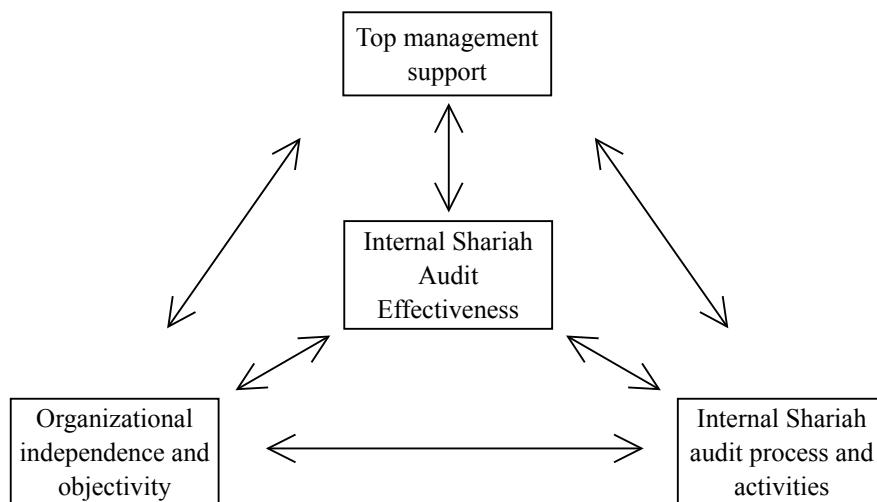
Relating this to ISA, the risk-based plan should be linked to the IFIs' Shariah risk management control framework that forms part of the IFIs' integrated risk management framework (Bank Negara Malaysia, 2010). IFIs are expected to have in place a robust integrated risk management framework that includes Shariah risk management.⁶ Therefore, Shariah auditors are expected to develop their risk-based audit plan based on IFIs' risk management framework related to Shariah risk management. Consequently, Shariah audit process that focus on high risks area would help Shariah auditors to provide assurance that risks are effectively managed through proper implementation of mitigating controls.

⁶ BNM had issued policies on Risk Governance, Operational Risk Management (concept paper) and guideline on Operational Risk Reporting Requirement — Operational Risk Integrated Online Network (ORION).

IV. Ecosystem of Internal Shariah Audit Effectiveness

ISAE can be said to be complex in nature as ISA unit or department is a part of the organization it operates. The business operations of IFIs are interconnected with each process is an input to another business process. For instance, the issuance of financing products starts with the research and development for the product, approval from Shariah Committee, marketing, product implementation and closure. Along this business process, Shariah compliance is observed via the implementation of Shariah internal control system, such as Shariah Committee approval of the product, Shariah compliance manual for product implementation and execution, standard operating procedures for accounting treatment, reporting and disclosure in the financial statements and annual report. Shariah audit function serves as the third line of defense and comes in last to provide assurance on the effectiveness of the existing internal control system and Shariah risk management process (Mohd Hanefah *et al.*, 2012; Daugherty and Anderson, 2012; PWC, 2012). Shariah audit function's success depends not only how the ISA is performed but also how it interacts with top management, the Board Audit Committee, Shariah Committee, and the department they are auditing (Albrecht *et al.*, 1988; Cohen and Sayag, 2010; Mihret and Yismaw, 2007; Arena and Azzone, 2009; Sarens *et al.*, 2012). Based on discussions in preceding sections, Figure 1 represents the determinants of ISAE.

Figure 1: Determinants of ISAE



Source: Adapted from Mihret and Yismaw (2007)

Figure 1 theoretically shows the interrelationship of the determinants of ISAE and the ISAE concept itself. In order for an IFI to have in place an effective ISA function, it requires

support from top management in terms of resources and direct communication with top management and the Board. The direct communication between ISA, Board Audit Committee and Shariah Committee is important for it to deliver its objective because both Committees need to approve the annual audit plan and audit findings must be reported to them as well. With adequate support and resources, ISA unit/department would be able to hire qualified staff and provide continuous training and development for Shariah related knowledge and risk-based auditing skills. Consequently, Shariah auditors would be able to conduct Shariah risk-based audit and produce quality audit reports. Quality audit reports has findings and recommendations that are substantiated by sufficient audit evidence and methodology. Shariah Committee members depend on valuable input and assurance from Shariah auditors for them to confirm that IFIs overall business operations are indeed in line with Shariah. Only then, Shariah Committee members are able to give assurance to stakeholders in the Shariah Committee Report that is mandatory to be published together with the IFI's audited financial statement (Bank Negara Malaysia, 2010).

The above interrelationship can be seen as a value chain in producing an effective ISA function. Without commitment and support from the Board, Shariah Committee members, top management and the audited departments, Shariah auditors could not provide assurance on Shariah compliance in an effective manner. It is imperative that all levels of management play their role as first, second and third line of defense so that overall Shariah compliance can be achieved (Daugherty and Anderson, 2012; PWC, 2012).

V. Conclusion

The sustainability of IFIs depends on how well management and the Board utilizes resources to operate within Shariah principles and earns halal profits. Stakeholders such as investors, shareholders and depositors rely on the assurance that ISA and Shariah Committee provides to the public that IFIs' operation are in line with Shariah principles. Specifically, ISA performs audit and assess how Shariah risks are mitigated with the implementation of controls and overall Shariah governance is operating as intended. With grave penalty instituted by IFSA 2013, Shariah compliance functions in IFIs struggle to ensure all level of business operates within Shariah principles. ISA as one of the Shariah compliance function plays it role in providing assurance on Shariah compliance. Knowing that its practice is valuable and effective lends credibility for its existence.

This paper investigates the concept of ISAE as well as arguing for three factors to be possible determinants of ISAE. ISA is expected to be effective when it is able to provide assurance on the effectiveness of internal control for Shariah governance, Shariah risk management and overall Shariah governance. The determinants were proposed to include top management support, organizational independence and objectivity and performance of ISA

process and activities as per BNM's SGF and IIA standards. These determinants and ISAE are interrelated in a value chain. ISAE can only be achieved by IFIs instituting an organizational structure that support independent ISA departments/units, providing adequate resources in terms of funds and capable manpower for effective performance of ISA. As a consequent of sufficient funds for its operation, internal Shariah auditors would be able to perform effective audit based on Shariah-related knowledge and skills to perform Shariah risk-based audit.

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