

# Shariah Review and Shariah Audit: Shariah compliance tools in Islamic banks

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## Abstract

Shariah review and Shariah audit serve as a second and third line of defense in Islamic banks. This study intends to analyse the differences between these two Shariah organs based on roles, guidelines and methodology, scope of duties, technology, independence, and reporting structure as well as officers' qualifications. A qualitative approach is used by employing semi-structured interviews with nine (9) practitioners. Data gathered from interviews have been transcribed and analyzed using Atlas.ti. Findings reveal that a clear function of Shariah review and Shariah audit is pertinent to effectively mitigate risks. This scenario could eventually provide a stimulus to improve governance and market confidence.

**Keywords:** Shariah compliance, Shariah review, Shariah audit, qualitative method

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## 1.0 Introduction

As the Islamic finance industry is growing, Shariah compliance assurance in the Islamic banks is becoming more critical. Undoubtedly, such compliance must be fostered throughout the organization as well as in its products and activities. Apart from the Shariah Committee (ShC) as a corporate governance mechanism in the Islamic banks, Shariah review and Shariah audit play their roles as a second line and third line of defense respectively to ensure the bank complies with Shariah precepts. The establishments of these Shariah organs as a line of defenses is primarily due to ensuring the Islamic financial institutions (IFI), including Islamic banks, fulfill the Shariah requirement (Bahari & Bahrudin, 2016).

Shariah review, as defined by Bank Negara Malaysia (BNM), is "a function that conducts regular assessment on the compliance of the operations, business, affairs, and activities of the IFI with Shariah requirements." At a minimum, the Shariah review function must identify, assess, and monitor the compliance of the IFI's business operations and activities with Shariah. The team should report to the Board of Directors (BOD), ShC, and senior management regularly on Shariah non-compliance (SNC) issues and findings and the latest developments in legal and regulatory requirements in Islamic finance.

The senior officer who is accountable for compliance matters is also accountable for Shariah review. This accountability is part and parcel of the IFI's overall compliance responsibilities in ensuring sound compliance risk management. Thus, an IFI must ensure that officers who perform the Shariah review function are qualified to perform compliance function responsibilities and have a sound understanding of relevant Shariah requirements applicable to Islamic financial business. On top of that, officers qualified to perform compliance function responsibilities may include officers with Shariah degree qualification (Bank Negara Malaysia, 2019).

Meanwhile, Shariah audit as the third line of defense refers to "a function that provides an independent assessment on the quality and effectiveness of the IFI's internal control, risk management systems, governance processes as well as the overall compliance of the IFI's operations, business, affairs, and activities with Shariah" (Bank Negara Malaysia, 2019). According to Shariah Governance, the Shariah audit function at least must establish an audit methodology to assess the risk profile, generate an audit plan, establish documented audit programs and communicate results to the BOD and ShC through an audit report.

The senior officer who is accountable for internal audit is also accountable for the Shariah audit accordingly. This accountability forms part of the overall internal audit function in an IFI. Therefore, an IFI must ensure that its internal auditors who perform the Shariah audit function are qualified to perform internal audits and have the requisite knowledge on Shariah requirements applicable to Islamic financial business. However, if the board of the company is not satisfied with the existing internal Shariah audit performance, the board may appoint any persons to conduct an independent external Shariah audit on the operations, business, affairs, and activities of the IFI. This exercise aims to provide objective assurance on the effectiveness of Shariah governance implementation within the

IFI. If the BNM believes appropriate for compliance with Shariah by an IFI, in line with section 37 of the IFSA, the BNM may require the IFI to appoint any persons as the BNM may approve to conduct an independent audit on Shariah compliance by the IFI. (Bank Negara Malaysia, 2019). A summary of the line of defense is provided in Figure 1.1 below:



Figure 1: Lines of defense pyramid in IFIs

(Source: Adapted from Mohd Hanefah, M., Shafii, Z., Salleh, S., & Zakaria, N. (2014))

However, even though BNM provides a series of guidelines and policy documents to industry players, many internal Shariah auditors and Shariah review officers are still unclear about their functions. Many of them only understand the differences conceptually, but they are still ambiguous in operationalization (Yazkhiruni, Nurmazilah, & Haslida, 2018). They further argue that the Shariah auditing process was ineffective due to repetitious tasks between Shariah audit and Shariah review procedures. Thus, comparing the roles and functions between these two organs rooted from primary sources seems important as endeavored in this study.

## 2.0 Literature Review

AAOIFI, through GSIFI No 2, describes that Shariah review plays a vital role in ensuring all activities in Islamic banks adhere to Shariah rules and regulations as suggested in the

fatwa, rulings, and guidelines issued by Shariah Supervisory Board (SSB) (AAOIFI, 2015). According to this standard, an effective Shariah review will deliberate and cooperate with advisors such as external auditor and shall provide a report concomitantly to the ShC and Management.

The Shariah review function is essential to adequately expound the Shariah governance practice (Masruki, Mohd Hanefah, & Ab. Wahab, 2018). In order to build a comprehensive Shariah-compliant environment in their operation and business activities, IFIs are expected to outline and perform the function of Shariah Review (Bank Negara Malaysia, 2011). The Shariah review department usually acts as a referral point for the internal audit department to confirm and clarify Shariah issues (Yazkhiruni et al., 2018).

Abu Samah & Hassan (2014) postulate that all the Islamic banks confirmed their full understanding of the difference between the Shariah review function and those of the Shariah audit. According to Shafii, Salleh, & Shahwan, (2010), the head of the Shariah audit is responsible for establishing plans for the review. Besides, he must also establish written policies to guide the Shariah review staff and establish a program to select and develop staff. Besides, it is also essential to ensure that the Shariah review and the Shariah audit are adequately coordinated.

Muhamad Sori, Mohamad, & Shah (2015) disclose that the Shariah review officer obliges to examine the operation flow and investigates SNC's incidence. Shariah review officer will visit all branches and divisions and perform relevant examinations. If the Shariah review function found any SNC incidence, they will provide feedback and require the respective branch or department to rectify the non-compliance. However, it is more towards an internal consultative nature than audit findings, which are more towards reprimanding or penalizing non-compliance.

Alwi (2007) asserts that, in general, Shariah review has been used by IFIs to ensure Shariah compliance. However, he feels that a Shariah review process is not sufficient since its scope is somewhat limited. Thus, he suggests the Shariah audit as a more appropriate tool to ensure Shariah compliance. It covers a broader scope of examination, including the technology supporting the operations, operational processes, and the people involved in the critical areas of risk.

At present, studies specifically comparing Shariah audit and Shariah review tend to be very limited due to the nature of this area. Thus, this study will add a piece of new knowledge to the existing literature given the fact of the scarcity of the Shariah audit literature. Previous studies tend to discuss the competency of the Shariah auditor (Alam, Hassan, & Ferdous, 2017; Mohd Ali, Shafii, & Shahimi, 2020) human capital development (Shafii, Salleh, Mohd Hanefah, & Jusoff, 2013) Shariah audit practice (Ahmad, 2017; Hisham Kamaruddin & Mohd Hanefah, 2017; Rashid, Abdul Hamid, Mohamad Sidek, Wan Abdullah, & Mohd Ali, 2017), the perceptions towards Shariah audit (Mohd Ali, Shahimi, & Shafii, 2018; Shafii, Zainal Abidin, & Salleh, 2015), and Shariah audit model (Shafii et al., 2015).

Besides, this study is different from past studies because many previous studies use a questionnaire survey method to gather data. According to Queirós, Faria, & Almeida (2017),

the reliability of data from the survey is very much dependent on its structure and the accurate answers provided by their respondents. On the contrary, the current study uses a qualitative method to collect data by employing semi-structured interviews.

Thus, this paper aims to fill this gap by analyzing the differences between Shariah audit and Shariah review based on practitioners' views. Even though prior scholars have continuously discussed this issue, this paper has its uniqueness. It gauges new data through a qualitative approach that would contribute to new knowledge specifically related to this area.

### 3.0 Methodology

A qualitative approach has been used in this study by employing an in-depth interview. By utilizing semi-structured questions during the interview sessions, it will open up free discussion between the researcher and participants in order to gauge as many as possible an uncover differences between Shariah audit and Shariah review.

Table 1 below presents a list of interviewees involved in this study. There are four groups of Islamic business operations available for this study, namely full-fledged Islamic banks (FFIB), Islamic banking subsidiaries (IBS), development financial institutions (DFI), and Islamic window (IW). FFIB refers to either local or international banks that only offer Islamic banking products or services. Their operation is ruled by the IFSA 2013. Besides, IBS is a conventional bank with an Islamic banking subsidiary whereby it is governed by the IFSA 2013 and the Financial Services Act 2013 (FSA 2013).

Meanwhile, DFIs refer to specialized financial institutions established by the government of Malaysia to develop and stimulate important sectors to achieve their socio-economics' objectives by offering Islamic products and services. DFIs have been categorized under the jurisdiction of the Development Financial Institutions Act 2002 and IFSA 2013 for their Islamic banking business operation. Surprisingly, some DFIs have transformed their entities and operations to become FFIB lately. Finally, IW is a commercial bank given a license by Bank Negara Malaysia to offer Islamic banking products and services. Like IBS, IW's activity is also administrated by the IFSA 2013 and FSA 2013 in their business operation

In this study, the selection of respondents is based on purposive sampling. According to Engel & Schutt (2014), a purposive sample is appropriate when the selected sample is based on the established objective and focuses on a group of experts such as internal auditor and Shariah officer. Even though the sample size is relatively small, consisting of 9 interviewees only, it is considered normal in a qualitative study because they are selected based on the criteria that provide useful information on the phenomenon under investigation (Creswell & Poth, 2018). Besides, the mix of the Shariah auditors, the heads of the Shariah audit, and the other industry players such as chief Shariah officer and ShC member would provide fruitful details on the subject matters (Mohd Ali, Mohamed, Shahimi, & Shafii, 2015).

The respondents were coded based on the position and types of groups. This approach certainly is to keep the confidentiality of the data. Finally, the interviewees for this study is presented in Table 1 as follows:

Table 1: Interviewees For The Study

Types of Group	Position	Respondent Code	Total
Full-fledged Islamic Banks (FFIB)	Chief Shariah Officer	CSO-FFIB	1
	Head of Shariah Audit	HSA-FFIB	1
	Head Office and Shariah Audit	HOSA-FFIB	1
Islamic Banking Subsidiaries (IBS)	Head of Islamic Banking Audit	HIBA-IBS	1
	Senior Director of Islamic Business Unit	SDIBU-IBS	1
Development Financial Institutions (DFI)	Head of Shariah Audit	HSA-DFI	1
	Shariah Auditor	SA-DFI	1
	Shariah Committee Member	ShC-DFI	1
Islamic Windows (IW)	Head of Shariah Audit	HSA-IW	1
			9

The study acknowledges the limitation since it does not collect the samples from the Shariah review officer due to the difficulties in getting the data.

Before the analysis can be performed, the verbatim transcription was accomplished for all interview sessions by employing the Computer Assisted Qualitative Design Analysis Software (CAQDAS), namely Atlas.ti version 8.0. This software is used to facilitate the process of transcribing the interview audio and data coding. Then, the researcher develops relevant codes from this transcription and generates appropriate themes that eventually presented in the findings section.

## 4.0 Findings and Discussion

### 4.1 Roles of Shariah audit and Shariah review

Even though the SGPD 2019 supersedes the SGF 2011, this new guideline continues the governance spirit with the policy that Shariah review should be conducted by the IFIs regularly. In the meantime, the Shariah audit should be performed according to its timeframe or period. An interviewee from FFIB verifies that:

*"...We have a clear cut between the two. Shariah review should always conduct its review regularly. Meanwhile, Shariah audit as the third line of defense has a specific time in performing the audit activity periodically..."(FFIB-HOSA).*

SDIBU-IBS compares these roles accordingly as follows:

*"...The role of Shariah review is more less what is the role performed by the compliance department in confirming that the bank at all times complies with the Shariah requirement. However, from an audit perspective, we audit post-event, whereby the business has done, the project has completed. Hence, Shariah review should be before, and Shariah audit should be after..." (SDIBU-IBS).*

Based on the above statement, it is evident that the Shariah review focuses on pre-event and, on the contrary, Shariah audit centers on post-event. On the contrary, the head of Shariah audit from DFI pinpoints a different perspective whereby he remarks that Shariah auditor focuses more on the internal control aspect as he mentions:

*"...Shariah reviewer checks whether the bank is complying with Shariah principles. Meanwhile, Shariah auditors focus more on internal control, whether internal control is strong enough to ensure no SNC issues..."(HSA-IW).*

This view is actually in line with Shafii et al. (2014) contend that Shariah auditors should be equipped with knowledge of financial statements and internal control systems of an Islamic bank.

However, a chief Shariah officer from FFIB has an exceptional view in comparing these two Islamic banks' organs. By employing terms 'ensure and assure', he elucidates that:

*"...I like to distinguish between Shariah review and Shariah audit using 'ensure and assure.' The role of Shariah reviewer is to 'ensure' and Shariah audit provides independence 'assurance.' Shariah review discharges responsibility on behalf of the management to ensure that the bank complies with the Shariah requirements. Meanwhile, Shariah audit plays a role to confirm by giving assurance that other organs in the bank have conducted in implementing the Shariah correctly..." (CSO-FFIB).*

The above statement implies that Shariah review discharges responsibility on behalf of the bank by ensuring that any resolution made by the Shariah Committee (ShC) is implemented. If something goes wrong, it must be rectified, and the Shariah audit plays their roles to check whether the process applies, the control intact, and there will be no exposure to SNC.

There is collaboration between Shariah review and Shariah audit in mitigating SNC risk. According to Abu Samah & Hassan (2014), Shariah review is conducted collaboratively with Shariah audit and Shariah risk management, with its essential implementation being to perform regular assessments continuously by reviewing that the activities and operations carried out by IFIs do not contravene Shariah principles.

## **4.2 Guideline and methodology**

In terms of the guideline, HIBA-IBS states that the Shariah audit follows guidelines provided by Shariah Governance Framework (SGF) and Institute of Internal Auditors (IIA) in performing its role. However, there is neither specific guideline nor standard provided for Shariah review as he remarks:

*"...Shariah audit is a profession. Whereas Shariah review is a function, and they are not governed by standards because there is no standard provided for them (Shariah review). So, they execute the process in achieving the objectives based on what they feel good. On the contrary, while executing*

*the process, we (Shariah audit) are abiding by certain standards..."(HIBA-IBS).*

Table 2: Differences between Shariah audit and Shariah review

Features	Shariah audit	Shariah review
Role	Assurance and Internal Control, Post-event	Compliance, Pre-event
Guidelines and methodology	IIA, SGF2011, SGPD2019	SGF2011, SGPD2019, own guideline (domestically recognised)
Scope of duties	Much wider, covers overall processes (micro and macro), covers whole transactions and entities	Much narrow, focuses on micro aspect only and limited to Shariah compliance function
Technology	T-mate, ACL software	Select manually
Independency	Independent party	Part of the management
Ability to audit/review ShC	Yes	No
Reporting line	Report directly to BAC, indirectly to ShC	Report directly to ShC, report administrative matters to BOD/management
Qualification	Internal auditors who have the requisite knowledge on Shariah requirements applicable to Islamic financial business.	Officers qualified may include officers with Shariah qualification.

Concerning methodology employed in executing their tasks, Shariah auditor entirely relies on SGF, standards issued, and circulated by BNM and IIA standard. HIBA-IBS again underlines that:

*"...We (Shariah auditor) systematically conduct our audit according to standard, whereas they (Shariah review) maybe have a certain level based on their standard, I mean domestically recognized. However, if they bring their methodology to other banks, it might be different. Nevertheless, for Shariah audit, wherever they go, the standard will be the same..."(HIBA-IBS).*

In this regard, HOSA-FFIB opines an identical understanding in describing the methodology used by the Shariah review based on her real experience in conducting an audit on Shariah review, as she notes:

*"...We (Shariah auditor) have experience in auditing Shariah review. However, it is a bit biased if I say that the Shariah audit is better in terms of working papers and substance because when we audit Shariah review, sometimes the document is not available. The way they conduct the review may be thorough, but they cannot provide the evidence even though the finding is stated clearly in the report ..." (HOSA-FFIB).*

Therefore, it is evident that the Shariah audit has a more systematic and structured methodology, guideline, as well as specific planning as compared to Shariah review in performing its roles.



### 4.3 Scope of duties

Regarding the scope of duties, HOSA-FFIB proposes that there should be a discussion between Shariah audit and Shariah review to reduce the redundancy of the scope of duties for both parties. In this regards, she mentions that:

*"...In terms of scope, we (Shariah audit) have a regular discussion with Shariah review. If we want to do any planning, especially annual planning, we will ask Shariah review to be present first because they have done their analysis normally. This discussion is to avoid any overlapping..."(HOSA-FFIB).*

The abovementioned statement is supported by Abd Rahman et al. (2018), whereby in preparing the Shariah audit plan, Shariah auditor may also get a piece of advice from other internal Shariah organs such as Shariah risk and Shariah review.

In terms of the scope of duties, HIBA-IBS claims that the scope for Shariah review is much narrow, and it just focuses on the micro aspect only since it is limited to Shariah compliance function as he remarks:

*"...The scope for Shariah review they are looking at the product, they are looking at the process, but they are not looking at the entity. They focus more on micro and limit their scope to Shariah compliance and Shariah requirement compliances only..." (HIBA-IBS).*

He further explains that unlike Shariah review, Shariah audit looks beyond the Shariah review scope. For instance, their scope extends to how to mitigate the credit risk, operational risk, market risk on the activity, and focusing on Islamic as well.

### 4.4 Technology

Another difference between Shariah audit and Shariah review could be identified through technology employed in executing their roles. Some interviewees argued that the Shariah audit is technology savvy because they employ the latest software in performing Shariah audit tasks. SA-DFI claims that:

*"...the Shariah review department in this bank does not use technology in their review, but for us (Shariah audit), we do have IIA. In IIA, they have sorts of T-mate and ACL. We use that as part of our technology to do sampling to find exceptions on Shariah. However, Shariah review still uses manual..." (SA-DFI).*

In line with the above argument, Ayedh, Mahyudin, Abdul Samat, & Muhamad Isa, (2019) propose that the banks should ensure employees who are in charge of any function related to Shariah (i.e., Shariah review, Shariah audit, and Shariah risk management) to have basic knowledge on IT and information system. Continuous training for IFIs' employees, covering the information system, and ICS issues related to Shariah compliance should also be considered by management.

#### 4.5 Independency and Reporting Line

One of the critical aspects that distinguish between Shariah audit and Shariah review is independence as well as the reporting line. Interestingly, ShC-DFI emphasizes the uniqueness of the Shariah audit as they can audit the ShC even though indirectly they (Shariah audit) need to report to the ShC as well, as she describes:

*"...Shariah review cannot check the ShC, but the Shariah audit can audit the ShC. It shows that Shariah auditor is more likely to be independent than Shariah review because they can still audit the ShC even though they have to submit an audit report to them..."(ShC-DFI).*

In terms of reporting line, as stated clearly in SGPD 2019, the Shariah audit will report to Board Audit Committee (BAC) and Shariah review needs to submit a report to ShC respectively (Bank Negara Malaysia, 2019). In this juncture, most of the interviewees agree that their institutions follow this practice accordingly except few interviewees highlight slightly different, especially from the operational aspect, for instance:

*"...In terms of reporting is also different. The Shariah audit reports directly to BAC. In contrast, Shariah review, they report to ShC, but at the same time, they report the administrative matters to the board. However, Shariah audit still reports to ShC indirectly..."(HOSA-FFIB).*

In a nutshell, there are apparent differences between reporting structure for Shariah audit and Shariah review, respectively, as per Shariah Governance 2019. However, some interviewees reported that there is an additional internal reporting line structure to strengthen the governance, such as from Shariah review to the management (dotted line) as well as to the BOD.

#### 4.6 Qualification of officers

According to Bank Negara Malaysia (2019), the Shariah audit must be performed by internal auditors, who have the requisite knowledge on Shariah requirements applicable to Islamic financial business. However, according to (HD-Edbiz, 2017), background in either Shariah or auditing alone is not sufficient in conducting the Shariah audit. Shariah auditors must also be qualified professionals in Islamic financial and commercial relations (muamalat).

On the other hand, Shariah review should be conducted by a qualified Shariah officer who holds at least a degree in Shariah, which includes study in Usul Fiqh (the origin of Islamic law) and Fiqh Muamalat (Islamic transaction/commercial law). Considering this guideline, an ShC from DFI confirms the practice at her bank by highlighting that:

*"...Based on SGF, the Shariah review must possess a background in Shariah. It is not acceptable for an accounting background to do the Shariah review. However, Shariah audit can be from Shariah degree background..."(DFI-SHC).*

The above finding provides evidence that it is a clear difference between Shariah audit and Shariah review in terms of qualification. The present finding is also supported by Abu

Samah & Hassan (2014) found that 85% of the officer conducting a Shariah review holds a bachelor's degree in Shariah. Meanwhile, Hassan et al. (2013) found a similar vein when they report that there were about 89.7% of dedicated Shariah officer conducted Shariah review as compared to less than half of the respondents or about 49.4% only from dedicated Shariah officer that conducts Shariah audit. In the meantime, Hassan et al. (2013) confirm the current findings by stating that around 88.5% of their respondents were internal auditors that conduct Shariah audit exercise as compared to only 17.9% of Shariah officers are conducting Shariah audit exercise.

## 6.0 Conclusion

This paper analyzes the differences between Shariah audit and Shariah review in Islamic banks in Malaysia. By employing semi-structured interviews with nine (9) key industry players, we analyze the differences in terms of the role, guideline and methodology, scope of duties, technology, independence and reporting line, and qualification of the officers.

Fruitful findings have been revealed from this study whereby the majority of the interviewees provide a clear insight with regards to differences between these two components. In terms of reporting lines, most of them state that Shariah audit reports directly to the BOD and indirectly to the ShC. Whereas Shariah review reports directly to ShC and, at the same time, administratively reports to management. Thus, some interviewees argued that the Shariah audit is much better in terms of independency level compared to Shariah review as they (Shariah audit) do not involve and reported to the management. Besides, the scope of duties of the Shariah audit is much broader because it does cover not only the Shariah compliance aspect but also operational aspects, including internal controls.

Concerning the technology used, some interviewees claim that the Shariah audit at their institutions tends to employ special software to facilitate audit works. On the contrary, they claim that the Shariah review relies on the manual approach, especially in choosing their samples. Regarding the methodology used, the Shariah review tends to focus on the Shariah compliance aspect only. In contrast, the Shariah audit covers the operational aspect as well. Finally, most of the interviewees state that the Shariah audit team must have the workforce with audit skills and experience regarding officers' qualifications. Meanwhile, Shariah review strictly follows what has been stipulated in the guideline whereby holding a degree in Shariah is a must to conduct Shariah review.

As for recommendations to strengthen the situation, the Shariah review team needs to widen its scope of duties by focusing not only on the Shariah compliance aspect but also on the operational aspect. They should also consider employing technology in their sampling procedure in order to increase the number of samples. Therefore, the investigation of SNC cases would be more productive and comprehensive due to the higher volume of samples. Besides, strong determination to upsurge the awareness on the importance of Shariah review and Shariah audit supported by consistent and robust collaboration between Shariah review, Shariah audit, Shariah risk management as well as

board support would speed up the delivering of both Shariah organs deliverables in compliance with the expectation of the framework (Abu Samah & Hassan, 2014).

In conclusion, Shariah review and Shariah audit play their roles, respectively, by giving assurance to the stakeholders that all businesses and operations of the Islamic banks comply with Shariah principles. By having a manifest function of Shariah audit and Shariah review, the Islamic banks can effectively mitigate SNC risks. This scenario could eventually provide a stimulus to improve governance and strengthen market confidence. Future research may consider samples from the Shariah review team, external auditor, and regulator to produce more robust and all-inclusive findings.

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