Chapter 15

Shari’ah Governance and Audit Assurance in Islamic Banks

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ABSTRACT

This chapter is about two major components namely Shari’ah audit (SA) and Shari’ah compliance (SC). The chapter evaluates the role and function of Shari’ah audit and Shari’ah committee and observes to what extent the Shari’ah audit helps in reducing Islamic banks’ risk exposure. Five banks were chosen to answer the research questions; and five Shari’ah officers from different groups of respondents, who are involved directly in the process of Shari’ah compliance/auditing in Malaysian Islamic Financial Institutions (IFIs), were interviewed. Findings of the in-depth interviews revealed that the Shari’ah Governance Framework (SGF) positively impacts SA. The research shows that the functions of Shari’ah audit are more specific and covers all aspects. It should possess good knowledge, both of Shari’ah and accounting/auditing. The majority of the respondents agreed that Shari’ah non-compliance risk in IFIs is minimal.

1. INTRODUCTION

The strength and stability of the Islamic financial system has gained worldwide attention especially during the global financial crisis that took place in 2008. After the crisis, the growth of Islamic financial institutions (IFI) was boosted and the total assets of Islamic financial institutions (IFIs) rose 19% in 2011 and 21% in 2012 as compared to less than 10% in the conventional banking system around the world. Contributions to corporate social responsibility (Abdelsalam, Duygun, Matallín-Sáez, & Tortosa-Ausina, 2014; Platonova, Asutay, Dixon, & Mohammad, 2018) and the improvement of financial development can be seen as the achievement and development of IFIs (Gheeraert, 2014; Gheeraert & Weill, 2015).

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With the improvement and rapid growth in the finance industry, Malaysia is documented as the third largest country in the world after Iran and Saudi Arabia to contribute to the overall assets of domestic banks at approximately 21.9%, while there was a 9.6% contribution to global Islamic banking in the year ending 2014. The outstanding achievement shown by Malaysia has placed the country within the world as having developed an Islamic banking system. This progress is due to the comprehensive and efficient governance framework embodied in the Shari’ah governance framework (SGF) which was enforced in 2011 (IMF, 2017). Shari’ah principles, which are the backbone of Islamic finance, are crucial for the confidence of stakeholders in IFIs. Therefore, the strength of governance practiced by IFIs is seen as promoting stakeholder confidence and enhancing the credit rating of IFIs (Ginena, 2014; Grassa, 2016; Ullah, Harwood, & Jamali, 2018).

In order to safeguard the interests of stakeholders, Shari’ah audit is compulsory for every IFI in Malaysia (Ghani & Rahman, 2015) and it is performed as an internal audit function. This function is responsible to provide assurance of risk management (Zakaria, Nurazalia, & Noraini Mohd Ariffin, 2016). Organisations that have an effective audit function are better and more stable in terms of risk exposure to fraud and mismanagement (Omar & Bakar, 2012). Shari’ah audit has become the main aspect of research interest in recent years. However, little is known about the roles and responsibilities of Shari’ah audit practice especially in mitigating Shari’ah Non-Compliance Risk (SNCR) in IFIs (Ghani & Rahman, 2015). The lack of knowledge and proper training regarding Shari’ah audits has led to the occurrence of Shari’ah SNCR in IFIs (Endaya & Hanefah, 2013, 2016). In addition, mistakes in understanding the terms, and wrong interpretation of fatwa by the Shari’ah audit staff is the cause of the occurrence of SNCR. Previous studies have focused on Shari’ah audit issues such as the aspect of separation between conventional and Shari’ah audit (Karim, 1990), human capital in implementing Shari’ah audit (Shafii, Abidin, Salleh, Jusoff, & Kasim, 2013) and the gap between the actual and the desired outcomes in implementing Shari’ah audit (Kasim, Mohamad Ibrahim, & Sulaiman, 2009) and research into Shari’ah audit effectiveness (Endaya & Hanefah, 2016). Even though many studies have been implemented, it is indeed difficult to find field studies concerning a review of Shari’ah audit after implementation of SGF 2011. Therefore, this area of study is worth exploring and to narrow the gap between theoretical and field study research.

This research aims to explore the quality of audit assurance provided by Shari’ah audit during a performance review of the risk management process in the light of the new implementation of SGF 2011 in helping to reduce the risk exposure of Islamic banks. This study uses semi-structured interviews with five respondents from five Islamic banks in Malaysia to gather valuable insight into the role of Shari’ah audit in mitigating Shari’ah non-compliance risk.

2. BACKGROUND

2.1 Concept of Shari’ah Governance

Islamic Financial Institutions (IFIs) are different from conventional financial institutions whereby the IFIs have the responsibility of ensuring their products, instruments, operations, and activities are in compliance with Shari’ah principles. Failure to meet the necessary requirements related to these principles will expose the IFIs to Shari’ah non-compliance risk. Shari’ah non-compliance risk (SNCR) is the risk that arises from the failure of a bank to comply with Shari’ah rules and principles as determined by the
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