

# Awareness Level of *Shari'ah* Scholars, *Shari'ah* Advisors, Auditors and Accounting Academicians Regarding *Shari'ah* Auditing Issues in Islamic Banks of Pakistan

Mahwish Tahir  
MCB Bank Limited

## Abstract

*Shari'ah* audit includes auditing and assurance processes for products, transactions, disbursements of financing, profit distribution, policy for depositors, penalty charges, accounting recognition and measurement as well as financial reporting. The study examines the awareness level regarding *Shari'ah* Auditing issues in Islamic Banks of Pakistan. Some of the areas under consideration are awareness of respondents regarding *Shari'ah* audit, the appointment of *Shari'ah* auditor their requisite qualification and regarding the scope of *Shari'ah* audit. Survey questionnaires were distributed among *Shari'ah* scholars, auditing practitioners of Islamic banks and accounting academicians as these are the practitioners who are facing the issues while performing their tasks in the field and their views are very crucial for the development of a stable *Shari'ah*-compliance framework. The study finds that the awareness about the issues of *Shari'ah* auditing in Pakistan is low among accounting academicians. Further, the collaboration of institutions is required to fill this gap and there is a need for harmonization of practices with global standards.

**Keywords:** IFIs, Awareness, *Shari'ah* Audit, Issues, Pakistan.

## 1. Introduction

*Shari'ah* Auditing has a key value as there is an increasing awareness among Islamic institutions that every institution must contribute towards achieving the objectives of the Islamic law-the *Maqasid Al Shari'ah* (Shahul & Yaya, 2005). This obligation is overpowering and includes all facet regarding life of Muslims. It includes a solution towards permissible activities and a remedy against impermissible activities. IFIs have mostly guaranteed their operational state by maintaining a strategic distance from negative activities. Not with standing, their way to deal with positive activities has been changed because of an absence of

regulations in the area. The collection of these standards means a perfect responsibility for every Muslim to enjoin righteousness and equity and preclude immorality, injustice and foul play. These standards subsequently represent the premise of individual's obligation and responsibility. The rule of vicegerency signifies that humans are the vicegerent of Allah on earth. The standard of heavenly responsibility streams from the principle of vicegerency and signifies that people will be responsible to Allah Almighty for their activities on the Judgement Day.

Islamic banking is defined as a system that is regularized by the rulings of *Shari'ah* with an addition of rules regarding risk management. In this regard, various rules and laws were amended in 1970's and early 1980's to facilitate the implementation of a Riba free banking in Pakistan and industry players were given a specific time line to convert them to a Banking system based on *Shari'ah* rulings.

Keeping in view the earlier efforts, Islamic banking was re-launched in 2001 to promote Islamic Banking and in 2003 Islamic banking division was established at SBP with the objectives of developing a *Shari'ah*-compliance framework as a parallel banking system with the best international practices. For this purpose, Islamic Banking Division is working on the adoption of standards as issued by IFSB and AAOIFI.

## **2. Problem Statement**

The purpose of this study is to explore and highlight the current awareness level and understanding of respondents regarding *Shari'ah* auditing issues in Islamic banks of Pakistan.

## **3. Aim and Objectives of Study**

The purpose of this research is to explore the perception and awareness about *Shari'ah* auditing and its issues among audit practitioners such as *Shari'ah* scholars, *Shari'ah* advisors, *Shari'ah* internal and external auditors, *Shari'ah*-compliance officers and accounting academicians.

## **4. Research Questions**

Following are the research questions based on research objectives:

- What is the awareness level of practitioners regarding the definition of *Shari'ah* audit and its terminologies as used in Islamic banks of Pakistan?
- Are they aware about the difference between the conventional and Islamic audit?

- How important it is to institute *Shari'ah* Audit as a separate discipline?
- What would be the qualification of *Shari'ah* auditors in Islamic financial institutions of Pakistan and who should appoint them?
- What are the core business departments of Islamic banks as covered by *Shari'ah* audit?
- What should be the audit framework and procedure for performing *Shari'ah* audit in Islamic banks of Pakistan?
- How independent is the role of *Shari'ah* auditors while performing their duties in Islamic banks of Pakistan?

## 5. Research Objectives

Linked to the above research questions, following are the research objectives:

- To investigate the awareness level of respondents about *Shari'ah* audit and their understanding about *Shari'ah* audit related terms.
- To examine the awareness level about the difference in *Shari'ah* and conventional audit.
- To study the need for establishing *Shari'ah* audit as a separate department.
- To identify the requisite qualification of the *Shari'ah* auditor for Islamic banks in Pakistan and those who appoints the *Shari'ah* auditor.
- To explain the *Shari'ah* audit framework and procedure of performing *Shari'ah* audit.
- To study the areas of business in Islamic banks as covered by the *Shari'ah* auditors.
- To study the independence level of *Shari'ah* auditors while performing their duties.

## 6. Significance of the Study

The present study examines the areas regarding the understanding of *Shari'ah* audit, issues regarding the appointment of *Shari'ah* auditor, their requisite qualification, awareness of respondents and issues regarding interdependency of the *Shari'ah* audit along with the scope of audit in Islamic financial institutions of Pakistan. The results of the proposed study would, therefore, increase knowledge in academia and would also be useful for policy considerations for practitioners in Pakistan such as policies and framework devised by SBP, SECP and IFSB etc.

## 7. Literature Review

Nilai, B. B., & Sembilan, N. (2014) explored the perception of undergraduates was explored in Malaysia and their findings suggest there is a significant difference between those who have exposure of Shari'ah audit and those who haven't. Based on the results of the study, the policy makers and institutions can play a vital role to produce better future Shari'ah auditors in the market.

Keeping in view the large number of legal issues in existing governance model, there is a need to implement an effective Shari'ah based system as failure to adopt stable and efficient legal framework will lead to serious concerns for Islamic finance industry. Hassan (2010) Nilai, B. B., & Sembilan, N. (2014) tries to measure the ideas of respondents for establishing Shari'ah Audit as a discipline and whether there should be a proper Shari'ah audit along with Shari'ah review. This study advocated that the role of Islamic banks is not satisfactory for promoting Shari'ah audit. Due to huge monitoring cost and transaction cost Islamic banks are unwilling to carry out audit along with review. (Rahman, 2014; Hameed & Mulyany, 2007) Most of the Shari'ah auditors are either trained in Shari'ah or in audit field. In order to reduce this gap there is a need to draft the competency requirement that includes the KSOC knowledge, skills and other characteristics to meet the expanding market needs.(ALI, Nor Aishah,2015).

In reference to Pakistan, a study was conducted to highlight the issues of training for Shari'ah advisors and this is only possible by providing a platform for bank staff, skills building courses for Shari'ah advisors as this will facilitate the improved governance of Shari'ah rules in Islamic financial institutions and will help to reduce the possibility of conflict between Shari'ah advisors and bank staff. Further courses offered by the educational institutions should be consistent with the globally acceptable standards .i.e; AAOIFI. (Hussain, & Parker, (n.d),2010). The studies on the duties, functions, obligations and independence of Shari'ah advisors (for example Mouamer, 1989; Abdallah, 1990; Rahman, 2004; Shafei, 2005)

Shari'ah compliance is an essential element because if they fail to comply their product may no longer be acceptable in the market. Another main issue that will impede the performance of Islamic Banks is the lack of standardizations and uniformity in adoption of standards and auditing guidelines due to lack of experience and skills of external auditors on Shari'ah principles. (Simpson & Willing,2000) Establishing the Supreme Audit Institutions (SAI) will realize not only Maqasid Al Shari'ah but also improve other economic goals of Islamic banks. (Khan, 2001) In order to ensure the credibility of financial statements

both external auditors and SSB should be independent in their roles. (Karim,1990) The Shari'ah Governance Framework (SGF) of Islamic banking institutions should cover the following areas (SBP,2014):

- i. A compelling system for the BOD oversight of the IBI's Shari'ah compliance environment*
- ii. Accountability of executive level management in execution of the system*
- iii. An independent Shari'ah Board selected according to Fit and Proper Criteria (FAPC) of SBP with one of its Shari'ah Scholar individuals functioning as Resident Shari'ah Board Member (RSBM) to guide the bank on every day and routine Shari'ah issues*
- iv. A Shari'ah Compliance Department to help the SB and to serve as course between the SB and the administration of the IBI*
- v. Shari'ah compliance review system to evaluate the effectiveness of the Shari'ah governance system presented by the SB and BOD*
- vi. Independent Internal Shari'ah Audit Unit (ISAU)*
- vii. External Shari'ah Audit to be performed.*

*Shari'ah* audit is not outlined by AAOIFI. However, GSIFI No. 2 defines *Shari'ah* review. Internal *Shari'ah* audit is an important element of internal *Shari'ah* controls process. The purpose of this function is to perform a check on *Shari'ah* audit related processes of the bank and to enhance *Shari'ah* compliance. This goal can only be achieved by accessing and evaluating the effectiveness of internal *Shari'ah* controls and conformity of activities with *Shari'ah* board Fatawas, AAOIFI standards and with other legal and regulatory policies. And these assessments and findings are further reported to Board of Directors, *Shari'ah* boards and senior management. Overall, this process is valuable to all stakeholders. Internal *Shari'ah* audit function also provides support services including training of employees, *Shari'ah* audit planning, coordination with *Shari'ah* board as well as with external *Shari'ah* audit firm and advisory services to management for new processes and *Shari'ah* controls (Ginena & Hamid, 2015).

In Pakistan, the execution of Shari'ah-compliant process is different and the framework ensures more controls and supervision on an ongoing basis as it involves the appointment of *Shari'ah* advisors for Islamic banks, *Shari'ah* compliance department and SB at State Bank of Pakistan. There is a FAPC for the *Shari'ah* advisor's appointment as advised by the SBP. This criterion covered not only ethical and moral aspects but also covered the qualification and experience areas as needed for issuing Fatawas regarding Islamic financial

transactions. The *Shari'ah* scholars are selected by the banks under approval from SBP to oversee Islamic banking operations in Pakistan.

*Shari'ah* Compliance inspection is the second layer that consists of a comprehensive inspection manual. This manual is required to check and control the execution of the contracts according to *Shari'ah* rules and fatawas. Further in next phase AAOIFI standards can also be adopted with certain modifications. In Pakistan, eight AAOIFI *Shari'ah* standards are being adapted and three accounting standards are issued by SECP and ICAP's Committee (IFAS- 1, IFAS-2, and IFAS-3) as per AAOIFI guidelines.

The third layer, the *Shari'ah* board at SBP consisted of 5 members initially in 2003, one is a chairman, one *Shari'ah* scholar as a member, a lawyer member well versed in laws related to Islamic finance, a Chartered Accountant who leads another committee of Institute of Chartered Accountants of Pakistan ICAP for devising AAOIFI standards with few modifications and one member is Director of SBP Islamic Banking Department who acts as a collaborator between the Islamic banks and the SBP. In 2012, one *Shari'ah* scholar has been added in this board. The role of this board is to give its ruling on conflicts and issues related to *Shari'ah* compliance inspection, product development and provide support for launching of new products (Akhtar, 2006).

Still, *Shari'ah* Auditing is a big challenge being faced by the Islamic finance industry as many areas of this subject are still in developing stage and industry players like Islamic banks, Financial and Educational institutions and Islamic Investors are not recognizing its importance (Gard, 2009). As per AAOIFI standards and other prevailing rules and regulations, it is mandatory for the banks to conduct *Shari'ah* Audit once in a year but due to lack of expertise and undeveloped policies framework to adopt *Shari'ah* auditing in full spirit is not possible. The foremost challenge for Islamic banks is to formulate the structure and framework which is fully conversant with the *Shari'ah* practices in order to develop trust among investors, depositors as well as among various market players (Aioanei, 2007).

### **7.1 Auditing from the Islamic Perspective**

In Islam, there is no difference between religious and worldly matters and Islam sees business as a subject of ethics and reliance on the *Shari'ah* rulings (Karim, 1996). Thus Islamic banks and Islamic financial institutions must follow *Shari'ah* rulings in all their business related transactions. Islamic economic system is based on the al-Qur'ān teachings and Sunnah (Siddiqi, 1982), and the purpose of

Islamic finance industry is to promote Islamic values based on justice, equality and a balanced system. Islam does not support any form of exploitation and encourages people to earn lawfully and spend wisely (Kasim, 2010).

The function of audit in Islamic territory is crucial as it shows that the auditor is not only accountable to stakeholders and users of financial results and statements but also to Allah Almighty.

### 7.2 Auditing in Early Islamic History

The foundation of *Shari'ah* auditing in Islamic history was derived from "*Hisbah*" which means to seek reward. Al Mawardi views *hisbah* as an important part of religious matters and this helps to safeguard the religion from any deviations and immorality (Ginena, & Hamid, 2015).

In early Islamic history, the function of *hisbah* was to monitor, control and prevent fraudulent acts and exploitations of buyers in the marketplace and this concept was explained by the al-Qur'an that motivates to follow the right path and avoid wrong ways (Kasim, 2010).

Prophet Muhammad (PBUH) also appointed a lady, Samra binti Nuhaik as a *muhtasib*. Khalifah Umar (R.A.) also acted as *muhtasib* and he himself visited the market carrying a stick and warned those who sold goods at high price and those who were cheaters.

### 7.3 Objectives of Auditing

The objectives of auditing are to get the views of an auditor regarding the reliability of the financial results and also to ensure that the financial statements are prepared according to the standards. The secondary objectives are to detect and prevent errors, frauds, mistakes or any embezzlement and to discover the imperfections in the internal controls in order to improve controls.

### 7.4 Comparison between Islamic and Conventional Audit

*Shari'ah* audit has unique features as it includes ethics, fiqh and ibadah in every business transaction (Shahul, 2009). The role of a conventional auditor is limited as he is accountable to the management and shareholders regarding financial issues whereas in Islamic finance, this role is not only restricted to management but considers society also and is required to preserve Islamic rulings (Khan, 1985). The main difference is that *Shari'ah* auditor has an additional layer of religious accountability besides reviewing financial statements. *Shari'ah* auditor is expected to fulfil his religious obligations

(Mirakhor, 2000). *Shari'ah* audit involves a defined procedure to obtain evidence and also assess whether the other dimension of economic, ethical, religious and social objectives are realized or not. Whereas in conventional audit, the opinion is given by auditors regarding the fairness of financial statements in order to maximize the profit for shareholders. Hence traditional approach is insufficient to discover the unethical issues and practices (Yussof, 2013).

Also, Mohiuddin (2012) explains that in traditional system, reporting and accountability is limited to superiors but in Islamic audit, reporting is not only limited to senior management but also to Allah Almighty. Similarly, in conventional audit, the auditor thinks that he is independent but in Islamic audit, he feels that he is a vicegerent of Allah Almighty. A traditional audit involves a detailed examination of financial statements, while *Shari'ah* audit involves checking all processes and procedures of an individual with regard to his work while preparing accounts or his good deeds to ensure that they are complete in all manners and good deeds are rewarded by Allah Almighty. The required qualification for an auditor is a professional degree but in *Shari'ah* audit, besides professional degree, he must possess the Islamic knowledge too. The traditional audit is governed by auditing and accounting standards such as IFRS, IAS, etc. whereas *Shari'ah* audit follows Islamic *Shari'ah*, fatwas and AAOIFI standards (Uddin, Ullah & Hossain, 2013).

### **7.5 *Shari'ah* Auditing**

*Shari'ah* audit is not outlined by AAOIFI. However, GSIFI No. 2 defines *Shari'ah* review. Internal *Shari'ah* audit is an important element of internal *Shari'ah* control process. The purpose of this function is to perform a check on *Shari'ah* audit related processes of the bank and to enhance *Shari'ah* compliance. This goal can only be achieved by accessing and evaluating the effectiveness of internal *Shari'ah* controls and conformity of activities with *Shari'ah* board fatwas, AAOIFI standards and with other legal and regulatory policies. And these assessments and findings are further reported to the Board of Directors, *Shari'ah* boards and senior management. Overall, this process is valuable to all stakeholders. Internal *Shari'ah* audit function also provides support services including training of employees, *Shari'ah* audit planning, coordination with *Shari'ah* board as well as with external *Shari'ah* audit firm and advisory services to management for new processes and *Shari'ah* controls (Ginena & Hamid, 2015).



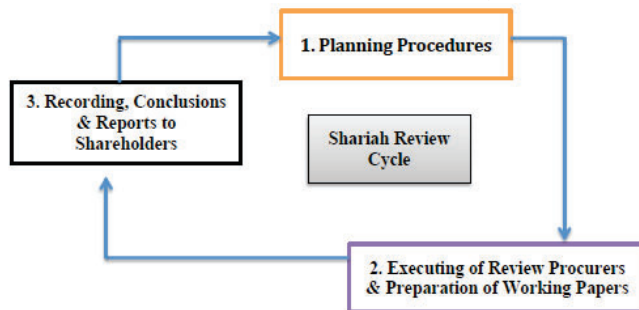
## 7.6 Objectives of Shari'ah Audit

The foremost objectives of *Shari'ah* auditing are to ensure that the activities and transaction performed by the Islamic financial institutions are not against *Shari'ah* principles and rulings. Further, *Shari'ah* audit covers examination of the financial statements along with other contracts and agreements with customers and to ensure that the institution complies with *Shari'ah* rulings (Sultan, 2007).

## 7.7 Phases of Shari'ah Audit

There are at least 3 phases of the *Shari'ah* audit i.e. Planning; Examination; and Reporting (Sultan, 2007). The first phase of *Shari'ah* audit is the collection, analysis, interpretation and documentation of information pertaining to the objectives of *Shari'ah* audit to support the results of the audit. This information may be collected through observations, inquiries, examination of documents and discussion (Shafii, Salleh & Shahwan, 2010). The audit plan is very important as it provides the basis to the audit process. This plan is depicting the picture of the whole activities that are undertaken by the auditors and explains the goals of each activity. For achieving these objectives, certain techniques are also used (Lahsasna, Ibrahim & Othman, 2013)

Figure 2.1: *Shari'ah* Review Cycle



Source: Rahman, J. M. (2014). The Current Perception and Practice of 'Shariah Auditing' in Bangladeshi Islamic Banks. Available at SSRN: <https://ssrn.com/abstract=2538568> retrieved on September 01, 2018.

In the planning phase, there is a need to set objectives of *Shari'ah* audit and decide the extent of audit work and then obtain the fatwas of *Shari'ah* board along with other guidelines, instructions and *Shari'ah* review results. The audit program is developed and this program will identify the key activities to be performed, and define the techniques to be used including examination of papers, surveys, flow charts, interviewing, bench marking and others. In examination phase, *Shari'ah* auditors collect, compile, analyze and at the end,

interpret the results based on documented information and to support the *Shari'ah* audit results. The information collected may be through exterminations of papers or documents, through observations, via analytical reviews, through verbal communications and discussions with the management. The quality and quantity of the information collected should be relevant and reliable and adequate to form the opinion on *Shari'ah* issues. During preparation of working papers by the *Shari'ah* auditors, it must be completed and comprehensive and should be retained as this information is reviewed by department heads and in future support the findings.

In the reporting phase, the outcomes of the audit activity and findings are compiled and communicated to users. The report must be clear, complete and constructive and the contents of these reports should include purpose, findings, opinions, scope, recommendations and response from the reviewers. These reports are shared with the board of directors, management, and *Shari'ah* supervisory board (Abdul, 2008). As per AAOIFI, the *Shari'ah* review procedure has the following phases: Review procedures planning; executing the review procedures along with working papers preparation and lastly, the documentation stage in which conclusions and reports are presented to shareholders (AAOIFI, 2008).

### **7.8 Role of Shari'ah Auditors**

In Islamic finance, the role of traditional auditors has been criticized by scholars (Yahya & Mahzan, 2012; Khan, 1985; Nejatullah, 2006). In the conventional system, the auditor is only responsible for providing assurance regarding financial matters to shareholders and management of the company but in Islamic audit, they are answerable to society too (Khan, 1985). The auditor should report to the management regarding the compliance with *Shari'ah* practices by the business set ups and to assess the practices of management (Khan, 1985). Some others researchers have similar views that there is a need to revise the functions of auditors according to the Islamic financial systems need (Al-Abiji, 1989; Nejatullah, 2006).

### **7.9 Global Shari'ah Auditing Standards**

#### ***AAOIFI Shari'ah Governance Standard***

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has issued 7 standards on *Shari'ah* governance for Islamic Financial Institution.

- 1) *Shari'ah Supervisory Board: Appointment, Composition and Report*,
- 2) *Shari'ah Review*,

- 3) *Internal Shari'ah Review,*
- 4) *Audit & Governance Committee for Islamic Financial Institutions,*
- 5) *Independence of Shari'ah Supervisory Boards,*
- 6) *Statement of Governance Principles for Islamic Financial Institutions,*
- 7) *Corporate Social Responsibility Conduct and Disclosure for IFI's.*

Further, Auditing standards ASIFI Auditing Standards for Islamic Finance Institution consists of 5 standards together with governance standards. ASIFI covers the audit areas related to financial statements whereas GSIFI considers the governance framework for ensuring *Shari'ah* compliance (AAOIFI, 2008)

**ASIFI No.1 - Objectives & Principles of Auditing:** The purpose of the audit is to express the view that financial statements are prepared in all aspects in accordance with *Shari'ah* Principles and Rules.

**ASIFI No.2 - Audit Report:** The statement that IFI is responsible for activities and reporting in financial statements, that these are in accordance with *Shari'ah* Principles. This report includes the following necessary parts:

- 1) Title.
- 2) Addressee.
- 3) Opening or introductory paragraph.
- 4) Paragraph regarding scope
- 5) A reference about the ASIFI's and related national rulings, practices and standards.
- 6) An explanation regarding the working of the auditor.
- 7) Opinion paragraph with an expression of views on the financial statements.
- 8) Paragraph's Date
- 9) Address of Auditors
- 10) Signatures of the Auditors

**ASIFI No.3 - Terms of Audit Engagement:** In order to maintain effective internal control environment, the management plays an important role as the management has to ensure that the *Shari'ah* rulings and fatwas are followed in true spirit and also make them accessible to an auditor for further confirming the compliance of these rulings and guidelines. Engagement letter, confirms that the auditor has accepted the appointment. Further, it defines objectives, scope and responsibilities of the auditors and also includes fees, agreements regarding terms of engagement and the required reports as provided by auditors. Management Representation, the auditor will ask the management for

operations of internal checks over reporting process and would expect from management to provide them with complete information.

**ASIFI No.4 - Testing for Compliance with *Shari'ah* Rules & Principles:** The term (auditor) refers to external auditors only and the aim of this standard is to give an opinion as to whether the said transactions are in compliance with fatwas and directions of *Shari'ah* board. The auditors also review the results and findings of internal checks as performed by internal audit divisions or management etc. Management is accountable for ensuring that the financial statements and activities are in compliance with Islamic principles and guidelines that are explained by ASIFI and governance standards. The auditor should know about the basic *Shari'ah* principles and these rulings and guidelines are the basis on which the auditors provide the opinion whether the Islamic rules are followed or not. The External auditor also satisfies himself that the procedures or process flow of new products or existing products modifications follow Islamic *Shari'ah* rules and are also reviewed by the management or by *Shari'ah* board. Finally, he provides the draft of the auditor's report to *Shari'ah* supervisory board.

**ASIFI No. 5 - The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements:** The error is explained as any unintended misstatement in financial results and statements and includes deletion or skipping of any facts and information. The error may be oversight of any *Shari'ah* ruling or error in accounting principles or their disclosures. Fraud is an intentional act by any person in management through employees or third party. Fraud may be the wrong allocation of profits, breach of contracts or intentional violation of *Shari'ah* standards or fatwas. Written representations should be obtained from management which include all matters of concern known by the management pertaining to fraud or errors and disclose that it has complied with all *Shari'ah*, accounting and auditing standards or guidelines issued by the *Shari'ah* supervisory board.

## 8. Research Methodology

### 8.1 Research Design

The main instrument employed for conducting a study will be closed-ended questionnaire due to its efficient and practical way of collecting data.

### 8.2 Population & Sample

This primary data was collected via questionnaire survey. Respondents were Accounting Academicians from Professional Educational Institutions i.e.; Faculty

of the Accounting & Auditing Programs in universities of Pakistan. *Shari'ah* Audit practitioners of the Islamic banks and Windows of Islamic banks in conventional banks in Pakistan. i.e. *Shari'ah* audit officers / internal auditors, external auditors, *Shari'ah* compliance Officers/ managers, *Shari'ah* scholars, members of the *Shari'ah* committee or *Shari'ah* board (SB) / *Shari'ah* Advisors.

**Table 1: Population of *Shari'ah* Members/Scholars**

No.	Categories of Banks	Total No of Banks	Total <i>Shari'ah</i> Members and Scholars	Sample
1	Full fledge Islamic Banks	06	17*	15
2	Islamic windows of conventional Banks	17	55	35
<b>Total</b>		<b>23</b>	<b>72</b>	<b>50</b>

\*The Total number of *Shari'ah* scholars/members in full fledged Islamic banks is 03 and Only MCB Islamic Bank has 02.

**Table 2: Population of *Shari'ah* Members/Scholars Bank wise**

Name of the Banks	No. of <i>Shari'ah</i> Advisors & Members
<b>Full Fledge Islamic Banks</b>	
1. AlBaraka Bank (Pakistan) Limited	3
2. Bank Islami Pakistan Limited	3
3. Burj Bank Limited	3
4. Dubai Islamic Bank Pakistan Limited	3
5. Meezan Bank Limited	3
6. MCB -Islamic Bank Limited (Subsidiary)	2
<b>Islamic Branches of Conventional Banks</b>	
1. Allied Bank Limited	3
2. Askari Bank Limited	3
3. Bank AL Habib Limited	3
4. Bank Alfalah Limited	3
5. Faysal Bank Limited	3
6. Habib Bank Limited	3
7. Habib Metropolitan Bank Limited	3

Table 2 explains the population of *Shari'ah* advisors/members and *Shari'ah* Scholars in Islamic banks of Pakistan. This data has been collected from websites of all banks.

8. MCB Bank Limited	3
9. National Bank of Pakistan	3
10. Silkbank Limited	3
11. Sindh Bank	3
12. Soneri Bank Limited	2
13. Standard Chartered Bank (Pakistan) Limited	3
14. Summit Bank Limited	4
15. The Bank of Khyber	7
16. The Bank of Punjab	3
17. United Bank Limited	3

**Table 3: Population of Accounting Academicians (Faculty)**

No.	Names of Universities	Total Accounting Academicians	Sample
1	UMT	06	06
2	IIUI	07	07
3	RIPHA	07	06
4	COMSATS	42	20
5	IBA CEIF	04	04
6	IM SCIENCES CEIF	07	07
	<b>Total Population</b>	<b>73</b>	<b>50</b>

Table 3 explains the population of accounting academicians and this information has been collected from the websites of the universities offering degree programs in Islamic banking, Islamic finance and accountancy.

### 8.3 Sample

The Sample consisted of 150 participants involved directly or indirectly within the process of *Shari'ah* auditing and compliance from 06 full fledged Islamic Banks and 17 Islamic windows of conventional banks and accounting academicians from 06 universities offering courses on Islamic finance and accountancy. Among them 50 are Shari'ah scholars, advisors or members of 50 are auditing practitioners of various Islamic banks and 50 are accounting academicians from universities were requested to fill the questionnaire. Out of 150 participants only 100 responses were received and used for further analysis using SPSS Software version 21.

Table 4: Response Rate Respondents Wise

	Frequency	Percent
<i>Shari'ah</i> SCHOLARS MEMBERS	23	23.0
INTERNAL AUDITORS	17	17.0
EXTERNAL AUDITORS	05	5.0
MANAGER <i>Shari'ah</i> COMPLIANCE	21	21.0
ACCOUNTING ACADEMICIANS	34	34.0
<b>Total</b>	<b>100</b>	<b>100.0</b>

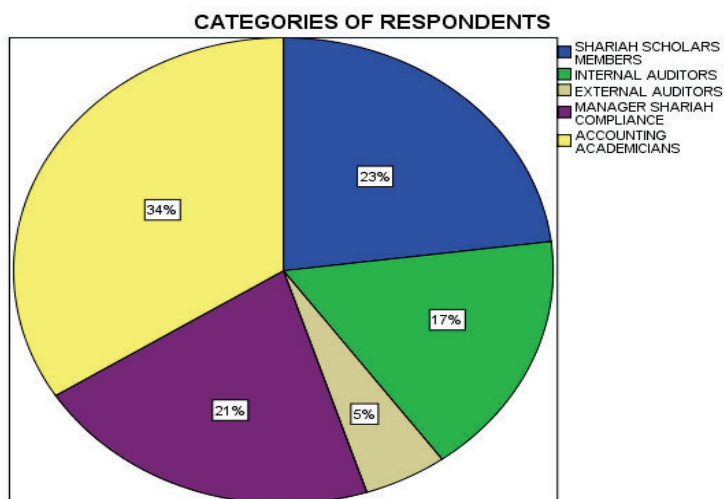


Table 5: Response Rate Respondents Wise

No.	Respondents	Total Distributed Questions	Total Received responses	Response Rate in (%)
1.	Accounting Academicians	50	34	68.00%
2.	Audit Practitioners	50	43	86.00%
3.	<i>Shari'ah</i> Scholars/Members	50	23	46.00%
<b>Total</b>		<b>150</b>	<b>100</b>	<b>66.66%</b>

The above table 5 explains the rate of response about the respondents where on the whole response rate is 67%.The maximum response has been received from Audit Practitioners i.e; almost 86%

#### 8.4 Data Collection Method

The present study used both primary data and secondary data for collection. This secondary data was collected from various articles, research papers, research studies, journals, books and e-journals. Based on this literature review, the research questions were generated which were tested through the collection of primary level data using questionnaire.

#### 8.5 Survey Questionnaire

In the first section of the questionnaire, some demographic details of the respondents was required. In next section, almost 70 questions were designed under 07 categories in which respondents provided their opinions regarding *Shari'ah* audit issues in Islamic banks of Pakistan. The answer is given in the form of likert scales of 05. See Appendix – A (Questionnaire).

### 9. Data Analysis

The collected primary data via using survey questionnaire was analysed through SPSS. Frequency distribution method and cross tab was used to observe the responses using various charts (Simple Bar, Clustered Bar & Pie charts etc.) were used for explaining the responses of the variables.

#### 9.1 Statistical Analysis for each Research Questions

Descriptive statistics, Cross tabs, frequency tables, pie charts and histograms are used for better interruptions of the results. Further reliability analysis was also conducted to check the strength and reliability of the questionnaire developed for the purpose of this research study.

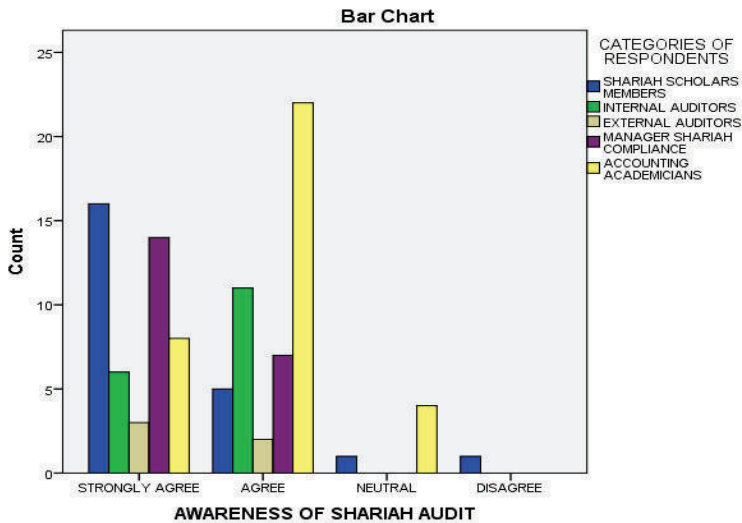
**Table 6: Awareness of the term '*Shari'ah* Audit**

		Categories Of Respondents				Total	
		<i>Shari'ah</i> Scholars Members	Internal Auditors	External Auditors	Manager <i>Shari'ah</i> Compliance		Accounting Academicians
Awareness of <i>Shari'ah</i> Audit	Strongly Agree	16.0%	6.0%	3.0%	14.0%	8.0%	47.0%
	Agree	5.0%	11.0%	2.0%	7.0%	22.0%	47.0%
	Neutral	1.0%	0.0%	0.0%	0.0%	4.0%	5.0%
	Disagree	1.0%	0.0%	0.0%	0.0%	0.0%	1.0%
Total		23.0%	17.0%	5.0%	21.0%	34.0%	100.0%



Regarding awareness level about *Shari'ah* audit, this table shows that almost 94% respondents were well aware about *Shari'ah* audit concept while 1% of respondents were unaware. Among the respondents 21% were *Shari'ah* Scholars, 30% were accounting academicians and remaining are audit practitioners. Further, as these results shows almost 5% respondents those are not very much sure about the term *Shari'ah* auditing and these respondents are accounting academicians.

Figure 3: Awareness of the term ‘*Shari'ah* Audit



**Research Question no. 1**

Based on the results, the study concludes that 94% respondents are well aware about *Shari'ah* audit out of whom most respondents are *Shari'ah* auditing practitioners, accounting academicians and *Shari'ah* scholars and those who are not well aware and still confused about this term are accounting academicians. The reason is less exposure of this subject in educational institutions. Further, only 52% respondents are aware of audit and accounting standards and 27% have neutral responses and they are also from academia. Similarly 87% respondents have basic knowledge of *Shari'ah* audit and only 3% respondents don't have any basic understanding and they are also from academia. Mostly respondents are aware of the terminologies of *Shari'ah* audit such as *Shari'ah* review, audit engagement, reasonable assurance and audit evidence. But these results are somehow different for Ex-ante and Ex-post *Shari'ah*-compliance as only 43% respondents are aware of these terms.

**Research Question no. 2**

This study concludes that 92% respondents are aware of the difference between *Shari'ah* and conventional audit and 75% respondents confirmed this fact that the *Shari'ah* audit framework is not like conventional audit framework. Mostly respondents from academics have no opinion.

**Research Question no. 3**

About 75% respondents opined in favour of establishing *Shari'ah* audit as a separate discipline to ensure proper controls and mostly the accounting academicians are supporting this concept of separate discipline and 45% are those respondents who support this fact as they have an opinion that it should be a separate discipline as this is cost effective. However, mostly accounting academicians says that establishing *Shari'ah* audit as a separate setup is not cost effective.

**Research Question no. 4**

Based on the results, this study concludes that external auditor from conventional audit should not perform *Shari'ah* audit, as 55% opined that *Shari'ah* scholars (Ulama) must not perform *Shari'ah* audit and many respondents are in favour of internal *Shari'ah* auditors should perform *Shari'ah* audit under the guidance of *Shari'ah* Board. Also, many respondents are confused whether the *Shari'ah* Board at SBP perform *Shari'ah* audit or not as only 34% are in favour that *Shari'ah* board at SBP can perform *Shari'ah* audit of Islamic banks in Pakistan. However, in comparison to other options, about 96% of the respondents support this fact that professionals certified in *Shari'ah* Audit should perform *Shari'ah* audit.

The study concludes that the *Shari'ah* auditor should not be appointed by shareholders through annual general meetings and mostly accounting academicians are not sure. Further, the appointment of *Shari'ah* auditor by SB at SBP is also not favoured by most of the respondents and again the ratio of accounting academician is greater than others and has no opinion. 49% of the respondents are against the idea of the appointments of *Shari'ah* auditor under Islamic Financial Service Board (IFSB) and 34% have no opinion and most of those who are against it are mostly *Shari'ah* scholars. However the appointment of *Shari'ah* auditor by a new supervisory body is the only fact that is supported by 82% of the respondents as they believe that there must be a new supervisory body for hiring the *Shari'ah* auditors.

This study concludes that almost 90% respondents agree that the *Shari'ah* auditor should have specialized certification in *Shari'ah* audit preferably. Then degree in both accounting and fiqh should be the requirement for *Shari'ah* auditors. A degree in auditing is only favoured by 47% and a degree in accounting is favoured by 50% only. Thus based on these figures, the importance of certification in *Shari'ah* auditing cannot be denied and combination of accounting, fiqh and auditing is supported by most of the respondents.

Moving forward, 87% respondents opined that there must be a separate scrutinizing body for appointment of *Shari'ah* auditors in Pakistan, and they must be trained in both banking and finance along with *Shari'ah* audit related risks and issues. The study concludes that 90% respondents support this fact that these financial institutions should provide training to *Shari'ah* auditors, 80% respondents opined that Professional educational institutions should also provide training to *Shari'ah* auditors.

#### **Research Question no. 5**

This study concludes that *Shari'ah* audit covers broader areas than the conventional one in Islamic banks of Pakistan. Further, the study concludes that 81% respondents say that *Shari'ah* audit is not be limited to audit of financial statements only and 66% of the respondents view that *Shari'ah* audit must not limited to financial agreements and contracts only. Mostly the respondents have no opinion due to lack of exposure whereas half of the respondents opined that it should not be limited to procedures and policies only. Further, the study also concludes that *Shari'ah* audit should cover these business areas such as policies, process, procedures, contracts, zakat calculation & reporting, financial system reporting, management of human resource, IT system, social activities, environmental impact of operations, contributions & marketing.

#### **Research Question no. 6**

The study concludes that 43% respondents say that the *Shari'ah* audit procedures are different among Islamic banks in Pakistan and 39 % are those who are not sure and have no opinion and thus this will impact the results and only 18% respondents, mostly *Shari'ah* scholars, say that the procedures and frameworks are similar among Islamic banks. Thus, there is a need to create awareness about *Shari'ah* audit frameworks and procedures and further, the practices of Islamic banks need to be standardized. Further respondents from the academia are not aware of this information and IT system is not sufficiently providing necessary data and information.

*Shari'ah* audit should be performed by surprise inspection and mostly the respondents do not support the other ways such as throughout the year, at the time of launching new products and at the end of financial years and the response from academia needs consideration. While considering the procedures for conducting *Shari'ah* audit, sampling method should be preferred over other methods of *Shari'ah* audit.

Further, the study concludes that the respondents have an opinion that accounting records, observations by auditors, SOP's, written communication with outsiders and legal documentations can be used as audit evidence. Also, 81% respondents are in favour of constituting separate auditing standards for *Shari'ah* auditing other than conventional standards.

#### **Research Question no. 7**

Based on the results, the study concludes that 92% respondents opined that the role of *Shari'ah* auditor in Islamic banks of Pakistan should be independent while performing his duty in order to keep more controls and to ensure *Shari'ah* compliance. Further, for achieving the goals of real independence 82% respondents say that the *Shari'ah* auditors should report to shareholders and mostly accounting academicians support this fact. While considering the number of *Shari'ah* auditors in Islamic banking institutions, 57% respondents say that the number of *Shari'ah* auditors in Islamic banks is not sufficient and this will impact the independence of *Shari'ah* audit as with fewer resources, the performance will be affected. Further, the study concludes that another element that will impact the independence of *Shari'ah* auditor is the lack of knowledge on the part of *Shari'ah* auditor and 71% respondents agree to this fact.

### **10. Conclusion**

*Shari'ah* audit includes auditing and assurance processes for products, transactions, disbursements of financing, profit distribution, policy for depositors, penalty charges, accounting recognition and measurement as well as financial reporting. In a broader view, the *Shari'ah* Audit must cover Maqasid Al *Shari'ah*, Aqad, screening for the prevention of Riba, Maysir, Gharar and other non permissible activities, documentation of contracts and financial considerations. Some of the areas that need consideration are financial and non financial implications of *Shari'ah* non compliance as if they are against *Shari'ah* ruling or against the directives of Allah Almighty, Impediment from blessing of Allah Almighty or contravening any Act or Law will impact the reputation of an IFI, their brands or product. Invalidation of contract (aqad) will make it non

halal income and financial impact may be leakage of income or may be the misappropriation of funds.

The frequency of conducting *Shari'ah* audit will depend on upon the size of an organisation. However, it may be phase wise checking with some defined parameters and audit plans and properly identifying the responsibilities of auditors and this should be a part of practice. It is need of the hour to have an extensive *Shari'ah* knowledge as well as financial qualification. Professional Education providers, as well as financial institutions, should offer certifications and short courses regarding *Shari'ah* based discipline. *Shari'ah* Committee is legally liable in the case of *Shari'ah* non-compliance and irregularities. If SAC violates any rules or regulations, there is a need to establish a centralized authority i.e; SBP to control or decides how to penalized them and to what extent. In short for realising the goals of *Shari'ah* audit the role of *Shari'ah* Supervisory Board should be independent and IBIs should outsource the *Shari'ah* audit to external professional auditor who is knowledgeable in *Shari'ah* and accounting.

Further the auditors responsibilities and reporting structure should be clearly defined, and he should report directly to shareholders. There is a question mark on effective Incorporation of audit in conventional banks providing services through Islamic windows as there are some critical issues regarding their fund's management & reporting area. Overall, this system is not so effective and needs improvement specifically from customers point of view. Also, the Management's Attitude is a critical area as they are not willing to bring every issue and matter in front of the *Shari'ah* Board as they are more interested in achieving their business goals and meeting targets at any cost. All Islamic Financial Institutions need to build a *Shari'ah* Control system to ensure *Shari'ah* compliance in each and every aspect of the banking operations.

## 11. Recommendations

### 11.1 Standardization of *Shari'ah* Audit Practices

It is the main role of the regulator to standardize the *Shari'ah* Audit practices in the country. The part of *Shari'ah* Governance Framework regarding *Shari'ah* Audit is a bold step towards the standardization of the *Shari'ah* Audit practices. It is the responsibility of SBP to monitor the *Shari'ah* Audit practices in different banks in Pakistan.

### **11.2 *Shari'ah* Auditors should be Registered Under Regulatory Body**

In order to achieve the objectives of true independence of *Shari'ah* auditors the regulatory bodies, such as SECP, SBP or Centralized *Shari'ah* Board should formulate the procedure of licensing and registering the *Shari'ah* auditors on their panels.

### **11.3 Need for Establishment of Education Hubs**

Academia owns the forum while a practitioner has knowledge of practical ground realities. There is a need to establish education hubs in professional institutions and in universities through the collaboration of Islamic financial institutions and regulatory bodies.

### **11.4 Need for Pooling of *Shari'ah* Scholars in Universities**

There is a need to educate and train the professionals and academicians on *Shari'ah* matters and in order to achieve this goal, *Shari'ah* scholars should provide training at institutional level.

### **11.5 Need for Offering Certifications in *Shari'ah* Audit**

There is limited number of institutions in Pakistan that provide certification on *Shari'ah* Audit. Mostly, the Islamic banks are not raising awareness, understanding and knowledge regarding *Shari'ah* audit. The courses on *Shari'ah* Audit should be designed and offered by institutions such as IBP, NIBAF, CEIF, LUMS, ICMAP and ICAP etc.

### **11.6 Need for on Job Trainings**

There is no particular qualification which can be attributed to a good *Shari'ah* auditor, the thing which matters the most is exposure and on-job training and learning from the *Shari'ah* scholars and Islamic bankers.

### **11.7 *Shari'ah* Audit as Separate Discipline**

*Shari'ah* Audit is a vast field that one may not perform accurately with the regular audit. The combination of both regular audit and *Shari'ah* audit will affect the performance of the auditor. There should be a separate set up for *Shari'ah* audit. Even the remuneration of the *Shari'ah* auditors should not be paid by the bank. Instead, there should be a centralized regulatory body in order to enhance independence.

### **11.8 Implementation of Global *Shari'ah* Standards**

At present, most of the AAOIFI standards are not fully complied in Pakistan due to the scarcity of resources, time, skilled staff and lack of interest of middle-level management. There is a need to implement and follow international practices in order to compete with the global partners. SECP, ICAP and SBP should play their role to implement global standards.

### **11.9 Curriculum of *Shari'ah* Audit**

The curriculum of *Shari'ah* audit should be part of accounting studies at graduation level in order to prepare the students for basic level. Side by side, where auditing subject is a part of syllabus, *Shari'ah* audit can also be added. Also ICAP, IIA and ICMAP can play a vital role by adding *Shari'ah* auditing as an additional course for professional accountants and auditors.

### **11.10 Availability of Literature**

The available literature on *Shari'ah* audit in our country is very limited. No book has yet been published in Pakistan that provides the detail regarding *Shari'ah* audit issues and *Shari'ah* audit framework in Pakistan. Even, the articles available are very limited.

## **12. Limitation of the Study**

First and foremost, this is a small scale study because it is an academic dissertation. So the sample size of the study is very limited as well. Also, limited staff in working in *Shari'ah* audit departments and difficulty was faced while approaching *Shari'ah* scholars and *Shari'ah* auditors due to their busy schedule. Literature available on *Shari'ah* audit is very limited especially with reference to the framework in Pakistan. Very limited articles and books are available in Pakistan.

## **13. Future Implications**

Since the ambit of *Shari'ah* audit is broader than conventional *Shari'ah* auditing practices and standards can be extended to other areas of banking operations. There is a need to discuss issues arising in the implementation of AAOIFI in Pakistan and there is a need to explore those channels through which these standards can be fully implemented.

In Pakistan, there is a need to study the impact of *Shari'ah* and governance standards on bank's performance and profitability. There is a need to study the pros and cons of establishing a centralized or supreme authority or structure to reinforce proper control for *Shari'ah* compliance and achieving the goals of independence. Further, there is a need to carry out the cost and profit analysis of establishing *Shari'ah* audit as a separate and independent unit.

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