



## Issues and Challenges in Shariah Audit Practices in Malaysian Shariah-Based Sectors

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**ABSTRACT** - This study aims to examine the current issues and challenges in implementing Shariah audit practices in several Shariah-based sectors in Malaysia, namely, Islamic financial sector, Islamic Capital Market (ICM), Islamic cooperative, public Shariah-based and Public Trust Entity (PTE). Furthermore, based on the findings, several future strategies are proposed to enhance Shariah audit practices. In this study, a series of Focus Group Discussions (FGD) was employed, and 124 participants from 76 Shariah-based institutions were involved through five FGD sessions. This study discovered that each Shariah-based sector has different issues and challenges in implementing Shariah audit practices due to the current Shariah governance and assurance practices in respective sectors. Thus, three main strategies were proposed that can be used to bring Shariah audit practices to another level for these Shariah-based sectors. This includes nurturing Shariah governance and assurance, developing specific Shariah audit scopes based on the uniqueness of each Shariah-based sector, and enhancing the professionalisation of Shariah auditors. Note that this study is considered a pioneering study in identifying the issues and challenges in implementing Shariah audit practices in various Shariah-based sectors. It also contributes by proposing the main strategies to enhance Shariah audit practices as a next step in the future.

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## INTRODUCTION

Shariah-based sectors in Malaysia are as old as the creation of the first formal Islamic banking institution. The historical development of Shariah-based sectors in Malaysia started with the establishment of Tabung Haji (TH), a Public Trust Entity (PTE), in 1962 under the Tabung Haji Act 1995 (Amendment). It is claimed that TH was the first financial institution in Malaysia that provided savings in accordance with Shariah to Malaysian Muslims who wanted to perform pilgrimage (*hajj*). Those who wanted to perform *hajj* would set aside savings to cover the costs. Consequently, TH invested these funds in productive sectors of the economy with the intention of making interest-free returns (Kamaruddin et al., 2019).

It was followed by the establishment of Bank Islam Malaysia Berhad (BIMB) in 1983 under the Islamic Banking Act 1983, which made it the first Islamic Financial Institution (IFI) in Malaysia. As a full-fledged Islamic bank with an initial paid-up capital of RM80 million, BIMB has since

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conducted its banking business side-by-side with other commercial banks while maintaining its main objective of being Shariah compliance (Laldin, 2008). Meanwhile, under the Islamic Capital Market (ICM) sector, the first Islamic equity index was introduced in Malaysia by RHB Unit Trust Management Bhd in 1996. Later, the Kuala Lumpur Shariah Index (KLSI) was launched on 17 April 1999 to cater for increasing demand by local and foreign investors who seek to invest in securities and instruments that are in line with Shariah principles (Ayedh et al., 2019a; 2019b).

On the other hand, Islamic cooperatives are also growing rapidly and becoming part of Shariah-based sectors due to the spillover effect of Malaysia's rapid growth of the Islamic finance industry from the 1980s to the present (Salleh et al., 2022). Nonetheless, Shariah-based sectors in Malaysia are believed to exist even before the so-called 'modern institutions'. This refers to the establishment of zakat and waqf institutions by the State Islamic Religious Councils (SIRCs) that are mainly involved with Islamic social finance funds like zakat, waqf, sadaqah, and infaq. These institutions were established prior to the independence of Malaysia.

At the international arena, Malaysia is recognised as one of the leaders in Islamic finance, with the potential and prospect for continued growth arising from the strong market demand of the country's dominant Muslim population and its high potential to serve the international market. For instance, the State of the Islamic Economy Report 2023 placed Malaysia as the leader in developing Islamic ecosystems for ten consecutive years, starting from 2013 (Liaqat, 2023). Similarly, the Islamic Financial Development Report 2022 ranked Malaysia in first place with a score of 113, far left behind Saudi Arabia in second place with a score of 74 (ICD-PS, 2022). Furthermore, the Islamic Financial Services Industry Stability Report 2023 identifies Malaysia as the third biggest country in terms of Islamic financial assets, with approximately 11.1% of the total global Islamic financial assets. In addition, Malaysia also has the biggest sukuk market, with approximately 47.2% of the total sukuk worldwide (IFSB, 2023).

Despite the rapid growth in Islamic finance, it must be admitted that not all Shariah-based sectors in Malaysia have the same pace. Apart from IFIs and ICMs, which are strictly regulated, other Shariah-based sectors, including Islamic cooperatives, Shariah-based public institutions in the public sector, including zakat and waqf institutions, as well as PTEs, are left behind in the development of the Islamic finance ecosystem itself (Kamaruddin et al., 2023). It is undeniable that as an institution based on Shariah, it is expected that these Shariah-based institutions will emulate Islamic values in all aspects. They need to have a reliable Shariah governance model and appropriate strategies that will drive the implementation of sound and effective Shariah governance in the Islamic environment (Hasan, 2010). This includes Shariah audit practices as one of the critical Shariah functions, especially in ensuring Shariah-compliant operations and offering Shariah-compliant services (Shafii et al., 2014).

Shariah audit can be described as a function that independently assesses the quality and effectiveness of internal controls, risk management systems, governance processes, and overall compliance of operations, businesses, affairs, and activities with Shariah (BNM, 2019). In other words, a Shariah audit is a tool or procedure to assure stakeholders that the operations of an organisation are in accordance with Shariah laws and principles (Hanefah & Kamaruddin, 2019).

There are several objectives in conducting a Shariah audit. First, Shariah audit practices will ensure the effectiveness of Shariah governance management structures, processes, and oversight. Second, Shariah audit practices will ensure the level of compliance with Shariah principles. Third, Shariah's audit practices will assess the effectiveness of internal controls in managing Shariah risk. Finally, Shariah audit practices will monitor follow-up actions on identified Shariah non-compliant activities, events, and transactions reported for correction or other actions required to ensure compliance with Shariah (Hanefah et al., 2020).

Based on the above Shariah audit objectives, there is a need to implement Shariah audit in all Shariah-based sectors to ensure that Shariah governance runs smoothly and further increases stakeholder confidence. However, it is believed that the current Shariah audit practices in these Shariah-based sectors are diverse due to the different approaches taken by respective regulators as

well as the different development growth of the ecosystem itself. Therefore, this study was called to examine the current issues and challenges in implementing Shariah audit practices in several Shariah-based sectors in Malaysia. This includes Islamic financial sector, ICM, Islamic cooperative, public Shariah-based, and PTE. Furthermore, based on the findings, several strategies are proposed for enhancement in Shariah audit practices in the future.

The structure of this paper is as follows. Next, the background of Shariah-based sectors in Malaysia will be discussed, and the Shariah audit practices for these respective sectors will be addressed. After that, this paper explains the methodology used in this research. Later, this paper presents the research findings and discusses the current Shariah audit practices and strategies proposed to enhance Shariah audit practices, especially for the respective regulators and institutional players. Finally, a summary and implications of the findings are in the last section.

## LITERATURE REVIEW

### Shariah-Based Sectors in Malaysia

The administration of the Islamic financial sector covers Islamic banks, takaful operators, and Development Financial Institutions (DFIs) in Malaysia under the jurisdiction of the Bank Negara Malaysia (BNM). At present, there are 17 Islamic banks, 15 takaful operators, and six DFIs in the Islamic financial sector. The list of these institutions by sector is included in Table 1 below.

**Table 1:** Islamic financial sector players in Malaysia

No.	Industry Player	Category
1	Affin Islamic Bank Berhad	Islamic Bank
2	Al Rajhi Banking & Investment Corporation (Malaysia) Berhad	
3	Alliance Islamic Bank Berhad	
4	AmBank Islamic Berhad	
5	Bank Islam Malaysia Berhad	
6	Bank Muamalat Malaysia Berhad	
7	CIMB Islamic Bank Berhad	
8	Hong Leong Islamic Bank Berhad	
9	HSBC Amanah Malaysia Berhad	
10	Kuwait Finance House (Malaysia) Berhad	
11	Maybank Islamic Berhad	
12	MBSB Bank Berhad	
13	OCBC Al-Amin Bank Berhad	
14	P.T Bank Muamalat Indonesia, Tbk	
15	Public Islamic Bank Berhad	
16	RHB Islamic Bank Berhad	
17	Standard Chartered Saadiq Berhad	
18	AIA Public Takaful Bhd	Takaful Operator
19	AmMetLife Takaful Berhad	
20	Etika Family Takaful Berhad	
21	Etika General Takaful Berhad	
22	FWD Takaful Berhad	
23	Great Eastern Takaful Berhad	
24	Hong Leong MSIG Takaful Berhad	
25	Prudential BSN Takaful Berhad	
26	Sun Life Malaysia Takaful Berhad	
27	Syarikat Takaful Malaysia Am Berhad	
28	Syarikat Takaful Malaysia Keluarga Berhad	
29	Takaful Ikhlas Family Berhad	
30	Takaful Ikhlas General Berhad	
31	Zurich General Takaful Malaysia Berhad	

32	Zurich Takaful Malaysia Berhad	
33	Bank Pembangunan Malaysia Berhad	
34	Small Medium Enterprise Development Bank Malaysia Berhad (SME Bank)	
35	Export-Import Bank of Malaysia Berhad (EXIM Bank)	Development Financial Institution (DFI)
36	Bank Kerjasama Rakyat Malaysia Berhad (Bank Rakyat)	
37	Bank Simpanan Nasional	
38	Bank Pertanian Malaysia Berhad (Agrobank)	

Source: BNM (2023)

BNM regulates and supervises the Islamic financial sector with a clear focus on Shariah compliance and governance to promote financial stability conducive to the growth of the Malaysian economy. Other than that, it is responsible for building the ecosystem of Shariah compliance and progressing toward the realisation of the value-based intermediary function. For this, several initiatives have been established and issued. This includes the establishment of the Shariah Advisory Council (SAC) of BNM in 1997, the Islamic Financial Services Act (IFSA) in 2013, the Value-based Intermediation (VBI): Strengthening the Roles and Impact of Social Finance in 2018, and the Shariah Governance Policy Document (SGPD) 2019.

The SAC BNM is the highest Shariah authority for the Islamic financial sector in Malaysia. Its roles and functions include the authority to ascertain Islamic law for IFIs. The SAC BNM's decisions shall prevail in cases of conflict or inconsistency of the Shariah opinions of the Shariah Committee in the IFIs (Hanefah et al., 2020). In terms of standards, IFSA 2013 provides for the regulation and supervision of IFIs, payment systems, and other relevant entities, as well as the oversight of the Islamic money market and Islamic foreign exchange. Meanwhile, VBI 2018 articulates strategies to strengthen the roles and impact of IFIs towards a sustainable financial ecosystem. It is defined as an intermediation function that aims to deliver the intended outcomes of Shariah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders' sustainable return and long term interests. VBI 2018 is the objectives set by similar frameworks such as Environmental, Social, and Corporate Governance (ESG), Sustainable, Responsible, Impact Investing (SRI), and ethical finance. However, VBI 2018 is rooted in Shariah, which determines its underlying values, moral compass, and priorities. Lastly, SGPD 2019 was issued to strengthen the oversight accountabilities of the Board of Directors, the Shariah Committee, and other key organs involved in implementing Shariah governance (Kamaruddin et al., 2020).

Meanwhile, the ICM sector is under the jurisdiction of the Securities Commission Malaysia (SCM). The ICM sector features 808 publicly listed companies (81.5% out of 991) classified as Shariah-compliant securities as of 24 November 2023. In addition, there are 36 Shariah-compliant securities in the LEAP market, five Islamic Real Estate Investment Trusts (i-REITs), and six Islamic Exchange-Traded Funds (i-ETFs) (SCM, 2023). These Shariah-compliant securities are summarised in Table 2 below.

**Table 2:** Islamic Capital market sector players in Malaysia as of 24 November 2023

No.	Industry Player/Fund	Category
1	Industrial Products & Services Industry (243 players)	
2	Consumer Products & Services Industry (165 players)	
3	Property Industry (95 players)	
4	Technology Industry (86 players)	Shariah-compliant Securities in Main Market
5	Construction Industry (62 players)	
6	Plantation Industry (35 players)	
7	Transportation & Logistics Industry (30 players)	
8	Energy Industry (27 players)	
9	Health Care Industry (26 players)	

10	Telecommunications & Media Industry (23 players)	
11	Utilities Industry (11 players)	
12	Financial Services Industry (5 players)	
13	Consumer Products & Services Industry (10 players)	
14	Industrial Products & Services Industry (11 players)	
15	Technology Industry (5 players)	Shariah-compliant Securities in ACE Market
16	Health Care Industry (4 players)	
17	Construction Industry (4 players)	
18	Energy Industry (1 player)	
19	Plantation Industry (1 player)	
20	Al-‘Aqar Healthcare REIT	
21	Al-Salam REIT	Islamic Real Estate Investment Trust (i- REITs)
22	Axis-REIT	
23	KLCC Property & REIT – Stapled Securities	
24	AME Real Estate Investment Trust	
25	MyETF Dow Jones Islamic Market Malaysia Titans 25	
26	MyETF MSCI Malaysia Islamic Dividend	Islamic Exchange- Traded Fund (i- ETFs)
27	MyETF MSCI SEA Islamic Dividend	
28	VP-DJ Shariah China A-Shares 100 ETF-MYR	
29	MyETF Dow Jones U.S. Titans 50	
30	Tradeplus Shariah Gold Tracker	

Source: SCM (2023)

Like the BNM in the Islamic financial sector, the SCM also established their own Shariah Advisory Council (SAC) in 1996 to advise the SCM on issues related to ICM to ensure its consistency with Shariah principles and issue Shariah Resolutions related to the ICM. The Shariah Resolutions act as a point of reference and provide clarity, certainty, and consistency to all market players in the industry. Furthermore, the SCM introduced the Shariah screening methodology as early as 1995 and revised it in 2012 by introducing a two-tier quantitative assessment. In addition, the Shariah screening methodology is an easy guideline for investors and fund managers seeking Shariah-compliant investment securities. This is as opposed to the conventional securities that are already known as not fully Shariah-compliant (Ayedh et al., 2019a; 2019b).

In 2022, the SCM issued the Guidelines on Islamic Capital Market Products and Services with enhancement on the aspect of Shariah governance and compliance that covers the aspect of perpetual tenure of registration of Shariah advisers, continuous professional development, and conduct requirements to enhance the monitoring and supervision on ICM, especially from Shariah perspective.

The Islamic cooperative sector is regulated by the Suruhanjaya Koperasi Malaysia (SKM), which plays a regulatory role in the cooperative sector, including the function of cooperative registration, supervision, and monitoring. Note that cooperatives in Malaysia can be divided into nine main functions, and both banking and credit cooperatives are the most significant in terms of asset and turnover size, which most Islamic cooperatives belong to (SKM, 2023). The details are provided in the following Table 3.

**Table 3:** Summary interim statistics of cooperatives in Malaysia as of 30 June 2023

No.	Function	Numbers of Cooperatives	Asset (RM Million)	Turnover (RM million)
1	Banking	2	126,990.36	22,984.49
2	Credit	561	15,628.15	3,045.56
3	Agricultural	3,553	3,908.42	836.99
4	Housing	313	1,088.73	96.04
5	Industrial	353	80.39	17.14
6	Consumer	5,582	2,576.58	969.85
7	Construction	262	125.29	50.15
8	Transportation	469	382.74	468.13
9	Services	4,461	11,177.53	2,525.94
<b>Total</b>		<b>15,556</b>	<b>156,181.16</b>	<b>161,958.19</b>

Source: SKM (2023)

Furthermore, to cater to the growth of the Islamic cooperative, Angkatan Kerjasama Kebangsaan Malaysia Berhad (ANGKASA) initiated the establishment of KOPSYA ANGKASA Berhad. This body was registered with SKM in July 2011, which offers innovative Islamic products featuring financing, deposit, and investment to the member cooperatives under the supervision of its own SAC. Moreover, the SKM also issued a guideline for Islamic cooperatives to administer Shariah governance, known as GP28: Shariah Governance Guidelines, in 2015. GP28 provides Shariah compliance guidance that will strengthen public confidence in the credibility of the Islamic muamalat system, especially in the cooperative sector.

On the other hand, public institutions with Shariah-based objectives under the government are becoming another sector that needs attention. Normally, the administration of Islamic religious affairs is given to the SIRC. Notably, the SIRC is responsible for advising the Head of the Islamic Religion on all Islamic matters except for Islamic law and administration of justice, which is within the power of the Shariah courts and muftis. The SIRC also manages Islamic wealth, such as zakat, waqf, baitulmal, and other Islamic funds (Kamaruddin et al., 2024).

At present, there are 14 SIRC in Malaysia. Each of the SIRC is established based on the Federal Constitution in accordance with Schedule 9 List 2, whereby the states in Malaysia are authorised to have the jurisdiction to govern the collection of zakat fitrah, waqf, baitulmal or/and other similar Islamic social funds (Mahadi et al., 2018). For zakat, there are 17 zakat institutions from 14 states in Malaysia. The management of the zakat institutions in some states separated the collection and distribution functions. In this case, eight institutions have been corporatised, and the remaining nine zakat institutions are non-corporatised (Kamaruddin & Hanefah, 2021b).

On the other hand, six waqf institutions can be categorised as corporations, separate from the SIRC, while nine other waqf institutions are departments embedded directly under SIRC (Kamaruddin & Hanefah, 2021a). Table 4 presents the list of all 17 zakat institutions, and Table 5 presents the list of all 15 waqf institutions in Malaysia based on their structure and functions.

**Table 4:** Zakat institutions under SIRC in Malaysia

State	Institution	Structure	Function
Johor	Majlis Agama Islam Johor (MAIJ)	Non-Corporate	Collection & Distribution
Kedah	Lembaga Zakat Negeri Kedah (LZNK)	Non-Corporate	Collection & Distribution
Kelantan	Majlis Agama Islam Kelantan (MAIK)	Non-Corporate	Collection & Distribution
Perak	Majlis Agama Islam dan Adat Istiadat Melayu Perak (MAIPk)	Non-Corporate	Collection & Distribution
Perlis	Majlis Agama Islam dan Adat Istiadat Melayu Perlis (MAIPs)	Non-Corporate	Collection & Distribution
Terengganu	Majlis Agama Islam dan Adat Istiadat Melayu Terengganu (MAIDAM)	Non-Corporate	Collection & Distribution

Melaka	Majlis Agama Islam Melaka (MAIM)	Non-Corporate	Distribution
Pahang	Majlis Ugama Islam dan Adat Resam Melayu Pahang (MUIP)	Non-Corporate	Distribution
Wilayah Persekutuan	Majlis Agama Islam Wilayah Persekutuan (MAIWP)	Non-Corporate	Distribution
Negeri Sembilan	Perbadanan Baitulmal Negeri Sembilan (PBMaINS)	Corporate	Collection & Distribution
Penang	Zakat Pulau Pinang	Corporate	Collection & Distribution
Sabah	Pusat Zakat Sabah MUIS (PZS-MUIS)	Corporate	Collection & Distribution
Sarawak	Tabung Baitulmal Sarawak (TBS)	Corporate	Collection & Distribution
Selangor	Lembaga Zakat Selangor (LZS)	Corporate	Collection & Distribution
Melaka	Pusat Zakat Melaka (PZM)	Corporate	Collection
Pahang	Pusat Kutipan Zakat Pahang (PKZP)	Corporate	Collection
Wilayah Persekutuan	Pusat Pungutan Zakat MAIWP (PPZ-MAIWP)	Corporate	Collection

**Source:** Kamaruddin & Hanefah (2021b)

**Table 5:** Waqf institutions under SIRC's in Malaysia

State	Waqf Institutions	Structure
Johor	Waqaf An-Nur Corporation Berhad (WANCorp)	Corporation
Perak	Wakaf Perak Ar-Ridzuan (WPAR)	Corporation
Pulau Pinang	Wakaf Pulau Pinang Sdn Bhd (WPPSB)	Corporation
Sarawak	Tabung Baitulmal Sarawak (TBS)	Corporation
Selangor	Perbadanan Wakaf Selangor (PWS)	Corporation
Wilayah Persekutuan	Pusat Wakaf MAIWP Sdn. Bhd (PWMSB)	Corporation
Kedah	Bahagian Wakaf MAINK	Department
Kelantan	Unit Wakaf MAIK	Department
Melaka	Bahagian Pembangunan Hartanah MAIM	Department
Negeri Sembilan	Jabatan Wakaf Negeri Sembilan	Department
Pahang	Unit Wakaf MUIP	Department
Perlis	Bahagian Pembangunan Wakaf, Hartanah & Mal MAIPs	Department
Pulau Pinang	Bahagian Pengurusan Hartanah and Wakaf MAINPP	Department
Sabah	Bahagian Wakaf & Baitulmal MUIS	Department
Terengganu	Seksyen Wakaf MAIDAM	Department

**Source:** Kamaruddin & Hanefah (2021a)

Based on the above organisational structure and formation, the governance practices of each zakat and waqf institution in Malaysia are varied. Normally, SIRC's are responsible for the overall monitoring function. For Shariah monitoring, most of the zakat and waqf institutions will refer to the State Fatwa Committee. Furthermore, several states have established a specific Shariah Department to cover daily Shariah activities and operations (Kamaruddin and Hanefah, 2021a; 2021b).

Lastly, PTE with Islamic objectives is also covered as part of Shariah-based institutions. Known as the PTE sector, PTEs can consist of government, non-governmental organisations, and Islamic foundations serving specific economic empowerment objectives. These entities collect funds from investors, depositors, or contributing members for special purposes outlined by the vision of the entities. Examples are the Employees Provident Fund (EPF), Lembaga TH, Kumpulan Wang Amanah Pencen (KWAP), Lembaga Tabung Angkatan Tentera (LTAT), and Permodalan Nasional Bhd (PNB) and Yayasan Pembangunan Ekonomi Islam Malaysia (YAPEIM). Some of these entities were established under an act of parliament or a foundation (Kamaruddin & Hanefah, 2024).

The PTEs manage significant amounts of funds collected from the public for the benefit of the contributors or depositors and the public at large. Some PTEs are collecting public funds through monthly deductions from the salary of donors. Therefore, these PTEs must have proper Shariah governance and audit for their Shariah-compliant offerings to ensure accountability and sustainability of the funds managed. The details of the main PTEs in Malaysia are provided in Table 6.

**Table 6:** Main PTEs in Malaysia

No.	Name	Financial Performance
1	Employees Provident Fund (EPF)	Assets: RM1.01 trillion Net Income: RM64.43 billion (EPF Annual Report, 2021)
2	Permodalan Nasional Bhd (PNB)	Assets: RM336.7 billion Net Income: RM11.79 billion (PNB Annual Report, 2021)
3	Kumpulan Wang Amanah Pencen (KWAP)	Asset: RM153.82 billion Net Income: RM8.87 billion (KWAP Annual Report, 2020)
4	Lembaga Tabung Haji (TH)	Assets: RM90.07 billion Net Income: RM1.94 billion (TH Annual Report, 2021)
5	Lembaga Tabung Angkatan Tentera (LTAT)	Asset: RM9.65 billion Net Income: RM79.3 million (LTAT Annual Report, 2019)
6	Yayasan Pembangunan Ekonomi Islam Malaysia (YaPEIM)	Assets: RM1.24 billion Revenue: RM53.77 million (YaPEIM Annual Report, 2019)

### Shariah Audit in Shariah-Based Sectors

Shariah audit practices in Malaysia began within the Islamic financial sector as part of the internal audit function. Since the introduction of the Shariah audit function by BNM through the Shariah Governance Framework (SGF) 2010, all IFIs under the Islamic financial sector need to conduct Shariah audit practice as part of regulatory requirements. More than ten years after the introduction of SGF 2010, current Shariah audit practices in the Islamic financial sector can be considered the most comprehensive compared to other Shariah-based sectors. This has been agreed upon based on a previous study that discovered practitioners in the Islamic financial sector are aware of and agreed on the importance of Shariah audit as a monitoring and control mechanism for attesting to Shariah compliance in IFIs (Isa et al., 2020).

Conversely, for the ICM sector, Shariah-compliant companies have no specific requirement to establish Shariah audit functions at the management level like IFIs. Therefore, Kasim et al. (2013) proposed having Shariah assurances like Shariah reviews and audit practices for Shariah-compliant companies in ICM sectors. Ideally, this suggests for Shariah audit to act as the third line of defence to control and monitor Shariah non-compliant risks and events. The first line of defence would be implementation of ICM guidelines by Shariah officers and front liners, then the establishment of Shariah review as the second line of defence. While the oversight on overall Shariah-compliant status would be from the SCM through its SAC that performs the Shariah screening methodology (Shafii et al., 2021).

However, another study by Hasan et al. (2020) on three selected Islamic fund management companies under the ICM sector revealed that these companies have good Shariah governance processes even without a comprehensive SGF for the ICM sector. Furthermore, they also observed that most Shariah functions, including Shariah risk management, Shariah review, and



Shariah audit, are conducted except for Shariah research. Thus, this finding motivates this study to examine the future growth of Shariah functions, especially on Shariah audit.

For Islamic cooperatives, it was discovered that Shariah audit cannot be implemented since some aspects are not properly explained from the point of view of Shariah governance, management, and products in the cooperative itself (Shah & Sharif, 2018). In this case, GP28 is yet to be adequate or comprehensive enough for Shariah audit practices. The irony is that a study by Salleh et al. (2022) stressed that Shariah audits must be conducted by Islamic cooperatives since most of them are offering Islamic financing contracts. In addition, they also discovered that Islamic cooperatives are aware of such needs but lack the manpower and knowledge to conduct Shariah audit practices.

Meanwhile, for the public Shariah-based sector, especially for zakat and waqf institutions, no single zakat and waqf institution in Malaysia publicly stated Shariah audit function in their organisational charts (Kamaruddin & Hanefah, 2021a). However, several previous studies agreed that there is a need for Shariah audit practices in these institutions. This includes controlling and managing risk related to Shariah compliance (Kaffah & Susetyo, 2020) to ensure that the collecting, managing, and distributing zakat and waqf funds are in accordance with the principles of Shariah (Megawati, 2018), as well as part of good accountability practices (Siswantoro et al., 2018).

Lastly, for the PTE sector, it is also argued that there is a need to conduct Shariah audits in PTEs. However, Hanefah et al. (2021) highlighted two main issues in conducting Shariah audit practices in the PTE sector. First, there is an absence of a mandate to conduct Shariah audit. Currently, there is no provision from the Federal Constitution and the Audit Act that clearly explains the need to perform Shariah audits in the PTE sector. Second, no specific standards have been created related to the Shariah audit for its use in the PTE sector. In addition, this study also listed three main challenges in conducting Shariah audits in the PTE sector. This includes weak Shariah audit knowledge, especially among government officers who conduct Shariah audits in PTEs, less experience being involved with Shariah audit processes, and inadequate training on Shariah audit itself.

In summary, it is undeniable that Shariah audit practices are required in Shariah-based sectors covering Islamic financial sector, ICM, Islamic cooperatives, public Shariah-based, and PTE. However, except for the Islamic financial sector, other Shariah-based sectors need more courage and strategy to push the implementation of Shariah audit practices in respective sectors. Thus, this motivates the aim of this study, which is to examine the current Shariah audit practices in these Shariah-based sectors in Malaysia. Further, based on the findings, several future strategies are proposed to enhance Shariah audit practices.

## **METHODOLOGY**

This study examines the current issues and challenges in implementing Shariah audits in several Shariah-based sectors in Malaysia, namely, Islamic financial sector, ICM, Islamic cooperative, public Shariah-based, and PTE. For this purpose, this study employed a series of Focus Group Discussions (FGD), one session for each Shariah-based sector, to collect the data. Each FGD session involves respective sector's stakeholders: Shariah auditors, Shariah officers, Chief internal auditors, the CEO, and even representatives from regulators. In total, 124 participants from 76 Shariah-based institutions are involved in five FGD sessions for this study. Table 7 summarises the information of these participants.

The involvement of participants portrays the diversity of Shariah-based institutions in Malaysia. First, these participants come from different Shariah-based sectors with different organisational structures and regulations based on their respective sectors. Second, these participants have various designations, roles, and views related to Shariah audit practices. Third, participants also have different attributes, especially in terms of gender, which could also provide more diversified views and opinions regarding Shariah audit practices in Malaysia. Finally,

respondents also have significant working experience in their respective sectors. Based on diversified participants' profiles, it is expected that these respondents will be able to provide comprehensive views and opinions to answer the research objectives of the study.

**Table 7:** Summary of participants' information

FGD Sessions	Summary of Participants
Islamic Financial Sector	16 participants from 13 entities: <ul style="list-style-type: none"> <li>• 8 Islamic banks</li> <li>• 4 Takaful operators</li> <li>• 1 Regulator body</li> </ul>
Islamic Capital Market (ICM) Sector	17 participants from 17 entities: <ul style="list-style-type: none"> <li>• 2 <i>i</i>-REITs</li> <li>• 3 Islamic brokers</li> <li>• 1 Crowdfunding company</li> <li>• 10 Islamic fund management companies</li> <li>• 1 External auditor</li> </ul>
Islamic Cooperative Sector	49 participants from 27 entities: <ul style="list-style-type: none"> <li>• 2 Banking cooperatives</li> <li>• 5 Credit cooperatives</li> <li>• 1 Agricultural cooperative</li> <li>• 12 Consumer cooperatives</li> <li>• 5 Services cooperatives</li> <li>• 2 Regulators</li> </ul>
Public Shariah-Based Sector	38 participants from 17 entities: <ul style="list-style-type: none"> <li>• 4 Zakat institutions</li> <li>• 4 <i>Waqf</i> institutions</li> <li>• 7 SIRC's</li> <li>• 2 Regulators</li> </ul>
Public Trust Entity (PTE) Sector	4 participants from 2 entities: <ul style="list-style-type: none"> <li>• YaPIEM</li> <li>• Tabung Haji (TH)</li> </ul>

The FGD focused on the Shariah audit practices based on interview protocols and lasted around two hours for each session. Consequently, interview protocol questions were prepared by focusing on Shariah audit issues and challenges as well as strategies to enhance Shariah audit practices in the future. These interview protocol questions were adopted from Hanefah et al. (2021) and Kamaruddin et al. (2024).

Meanwhile, for reporting purposes, this study used a single-case study approach (Yin, 2018). In this case, all findings from all FGD sessions were analysed and combined into a single writing. Using this approach will provide an in-depth understanding, especially of the current Shariah audit issues and challenges faced in each Shariah-based sector in Malaysia. In addition, to ensure that every statement was documented, the interviews were recorded. All FGD sessions were conducted and completed online through Microsoft Teams.

## FINDINGS AND DISCUSSIONS

### Shariah Audit Issues and Challenges in Shariah-Based Sectors

This section discusses the empirical findings on the current issues and challenges in implementing Shariah audits in each Shariah-based sector in Malaysia. For the Islamic financial sector, it was discovered that the current Shariah audit practice in participating IFIs has embedded Shariah audit

as part of their operational and risk-based audit coverage. Currently, there is a lack of a specific Shariah audit framework issued by regulators (Omar, 2019). Therefore, IFIs use the existing international internal auditing standards to guide the performance of their Shariah audit. This is similar to a previous study conducted by Othman and Ameer (2015), where most IFIs utilised the conventional auditing method due to the non-availability of a Shariah auditing approach. Further, participating IFIs have enhanced the audit coverage and frequency; some even have dedicated Shariah audit units.

Based on the FGD session for the Islamic financial sector, the following issues were raised, which are: (i) inadequate knowledge of operational Shariah issues, (ii) inadequate training programmes related to internal Shariah audits, and (iii) inadequacies in performing risk-based Shariah audit. In addition, responses during the FGD session pointed out that Shariah auditor should have experience in business and control functions such as compliance, Shariah compliance review, and risk management as this allows more effective detection of failure points given the auditor has a full understanding of the areas being audited.

The above issues highlighted by respondents relate to the competency of the Shariah auditors regarding auditing skills and operational Shariah knowledge. Shariah auditors need to be aware of various Shariah issues and regulations affecting the institutions to the extent that they impact the financial statements and overall operations. In order to bring Shariah compliance to the next level, it is crucial not only for the rules and framework to be formalised but also for having the right talents with adequate skills and knowledge in both Shariah and accounting disciplines. This will be key to driving the implementation of Shariah compliance in the industry.

Meanwhile, for the ICM sector, the FGD participants highlighted the following issues in relation to Shariah governance and assurance, which are: (i) inadequate knowledge of front liners in operational Shariah issues; (ii) inadequate internal auditors well-versed with ICM and fund management; and (iii) inadequate talent for the appointment of compliance officers or Shariah auditors.

In addition, the FGD participants opined that several functions are required regarding the practice of internal Shariah audits in the ICM sector. This includes the internal audit and compliance officers for Islamic fund management companies, compliance officers for i-REITs and i-ETFs, and diverse practices in the industry, as some entities require Shariah advisers to perform the review/audit. Meanwhile, some entities have internal audit reviews and submit reports to Shariah advisers. This is consistent with the previous suggestion by Kasim et al. (2013) for the ICM sector to have its own SGF.

Furthermore, participants also raised several other issues regarding implementing the Shariah audit. First, there are inadequate experts for Shariah auditors and the development of Shariah audit programmes. In addition, existing internal auditors are not well-versed in ICM and Islamic fund management activities. Moreover, there is also limited knowledge of Shariah Review and Shariah audit officers about new financial products. Therefore, it can be concluded that these issues are related to knowledge and talent management in the areas of Shariah audits.

There are more issues and challenges for the Islamic cooperative sector than in the previous two Shariah-based sectors, as currently, there is no specific act that governs Islamic cooperatives. Moreover, the absence of a specific act or regulation for an Islamic cooperative may trigger issues in cases where the current regulation may not comply with Shariah principles or hinder the process of Shariah compliance (Itam et al., 2016). This triggers whether the present cooperative mechanisms can ensure compliance with Shariah principles and the maqasid. For example, the application of the ar-rahnu contract in contrast to *tawarruq* as the underlying contract for micro-financing offered by ar-rahnu operators and cooperatives had caused inconsistencies in practices.

At present, ANGKASA conducts audits on the Islamic products offered by the cooperatives. The audit is conducted on the cooperative that wishes to obtain a Shariah-compliant product status. Although GP28 was issued by the SKM, the implementation and enforcement is

minimal due to its non-mandatory adoption. This guideline is provided for cooperatives, and the main function of giving credit to its members refers to banking and credit cooperatives.

At the KOPSYA level, Shariah governance mechanisms are being explored in its Management and Shariah Development Section. As KOPSYA is serving its members with the provision of Shariah-compliant products, KOPSYA's model of governance and assurance could serve as the benchmark for other cooperatives to follow suit. As the concerns for Shariah compliance have introduced a new dimension of governance, which falls under the corporate governance framework, the governance in Islamic cooperatives would support the members to maintain Shariah governance to comply with Shariah where the rights of the involved parties are protected.

During the FGD session for the Islamic cooperative sector, participants highlighted several issues and challenges in implementing Shariah audit, including (i) diverse practices as some Islamic cooperatives have internal Shariah committees while others outsource depending on the size of Islamic cooperatives; (ii) the issue of limited available Shariah scholars to sit as Shariah committee in Islamic cooperatives; and (iii) SKM as regulator still in the process to establish their own Shariah functions.

With regards to internal Shariah audit practices, currently, internal Shariah audits are performed either by a Shariah officer/internal audit or an externally appointed Shariah committee/adviser. Moreover, the smaller size of Islamic cooperatives has limited resources. Thus, there is no segregation of duties between Shariah officers and auditors. In addition, a limited number of staff members have knowledge of Shariah concepts and audit techniques. Lastly, they require a standardised audit checklist endorsed by SKM.

On the other hand, implementing Shariah audits in the public Shariah-based sector is crucial, especially as it will add value and nurture public confidence in accountability and transparency. During the FGD session for this sector, the participants shared several issues and challenges, which were also highlighted by Kamaruddin et al. (2024). This includes (i) the absence of clear Shariah audit scopes, (ii) no standard on Shariah compliance guidelines, (iii) unstandardised Shariah audit practices among institutions, and (iv) a shortage of talent in Shariah audit.

At present, Shariah audit is implemented within the scope of internal audit where the line of reporting is within internal audit and governance, under the oversight of the audit and risk committee. In addition, the existing audit plan is compact, and the budget allocation is limited with the currently limited staff. Moreover, most Shariah-based institutions under the public Shariah-based sector are currently referring to the state fatwa committee that plays Shariah supervision roles in the absence of the Shariah committee.

Lastly, the FGD session conducted for the PTE sector identified several issues and challenges in implementing Shariah audit practices, such as (i) inadequate knowledge of operational Shariah issues, (ii) inadequate training programmes related to internal Shariah audit, and (iii) inadequacies in implementing risk-based internal Shariah audit.

Currently, both TH and YaPEIM are only investing in Shariah-compliant companies. As such, they have established Shariah advisory committees and Shariah units to oversee their investments. Existing audit processes are undertaken by an internal audit department. However, there is no documented evidence in their annual report or website that Shariah audits were conducted by these PTEs. Since TH and YaPEIM's investments are only in Shariah-compliant companies and businesses, there is a need for Shariah auditors to conduct audits.

On the other hand, since their establishment, EPF and PNB have been investing in conventional and Shariah-compliant companies. Therefore, dividends from non-compliant companies were declared the need to be cleansed. Additionally, Shariah audit needs to be present to ensure the mechanisms of approving and monitoring parties to oversee the cleansing of Shariah non-compliant income from mixed portfolios are in place. This is consistent with the suggestion by Nasir et al. (2020) that these PTEs must have strong Shariah governance and assurances, especially as they manage a huge number of funds.

In summary, it can be concluded that all Shariah-based sectors have their own issues and challenges in implementing Shariah audit practices. With respect to these dissimilarities, proposed strategies for future action plans are required to recognise these differences and strengthen both Shariah governance and audit practices.

### **Proposed Strategies for Shariah Audit in the Future**

By acknowledging the dissimilarities among Shariah-based sectors in Malaysia regarding issues and challenges in implementing Shariah audit practices, this study proposed three main strategies that can be used to bring Shariah audit practices to another level for these Shariah-based sectors.

#### *Strategy 1: Nurturing Shariah Governance and Assurance*

Shariah governance is a prerequisite for the good conduct of Shariah audits as it develops the foundation of monitoring mechanisms for Shariah compliance. Consequently, Shariah audit assures Shariah compliance. The identified goals and desired outcomes need to be strengthened by the action plans that comprised of expanding the capacity of Shariah by establishing a robust foundation of Shariah in each of the sectors. The intended outcome is for all Shariah-based sectors to practice a robust Shariah governance and assurance framework. Effectively, this will gain the confidence of stakeholders that all activities conducted by Shariah-based sectors comply with Shariah.

All five sectors have undergone different phases of Shariah governance and assurance development. Therefore, the action plan must also be in line with the needs of each sector to establish sound Shariah governance and assurance across all the Shariah-based sectors. In the case of the Islamic financial sector, although BNM's SGF and SGPD have been a guide to ensure good governance practice, new developments in IFIs require better governance and regulations to ensure IFIs comply with Shariah principles at all times. Notably, new developments in the Islamic financial sector include digital banking, fintech, and e-wallets (Rahim et al., 2021). These developments can compete with IFIs, and others may complement the IFIs current functions to provide better customer service. However, experts in these areas are not many, especially in the field of Shariah digital banking and fintech. Shariah risk management experts in these areas are also rare. To address this issue, the action plan to be adopted is to provide training programmes on Shariah governance aspects for digital banking, fintech, and e-wallets.

Similarly, the ICM sector has also developed over the years in Malaysia. It is dynamic and robust and contributes to the economic development of Malaysia. However, as the ICM sector is a key component of the Islamic finance sector, it needs to have a SGF to gain total trust among domestic and international investors (Kasim et al., 2013). Moreover, trust and confidence among investors are vital for the growth of ICM in Malaysia. The SGF will ensure good governance practices when issuing Islamic financial instruments. Therefore, the framework should be supported by audits conducted by Shariah auditors to ensure assurance to investors and the public.

It is suggested that Shariah auditors in the ICM sector join Shariah audit training to enhance their Shariah auditing knowledge and skills. This aligns with the need for a strong Shariah governance mechanism based on the recent issuance of the Guidelines on Islamic Capital Market and Services in 2022. Further, Shariah audit training sessions are also able to create awareness of the critical aspect of Shariah governance for various Islamic financial products offered in ICM.

Meanwhile, the Islamic cooperative sector is known to play a vital role in the formal economy of its members. Many are involved in various industries, such as agriculture, financing, fishery, and trading, to name a few. Besides assisting Small and Medium Enterprises (SMEs), Islamic cooperatives also provide financing for their members. Note that Islamic financing provided needs to comply with Shariah laws. For this, the sector could adopt Shariah governance best practices that feature a Shariah advisory council to advise the Islamic cooperatives and the appointment of internal and external Shariah auditors to assure their members that the operations fully comply with Shariah (Hassan et al., 2018). Given the uniqueness of these institutions, Shariah

auditors in Islamic cooperatives need to understand and possess the Shariah auditing knowledge to conduct such an audit.

On the other hand, for the public Shariah-based sector, it is an undeniable fact that zakat and waqf institutions especially play a vital role in the economic development of Muslims and non-Muslims. Zakat collections are for specific groups and purposes, but waqf assets and properties can benefit all Muslims and non-Muslims. Each year, the collection for both funds exhibits an uptrend. However, several studies suggest that better governance must be in place for these institutions to serve the community in accordance with Shariah principles (Fajrin et al., 2020). Thus, the adoption of a SGF should be promoted in these institutions. Like other Shariah-based sectors, public Shariah-based institutions could adopt Shariah governance best practice that includes the appointment of internal and external Shariah auditors to ensure full compliance with Shariah (Kamaruddin & Hanefah, 2021a). This is to gain the public trust to deliver accountability and good performance for the success of these institutions.

Similarly, the PTE sector is also becoming another Shariah-based sector that needs to be focused on promoting Shariah governance and assurance. As these PTEs manage huge Islamic investment funds, the call to have strong Shariah governance and assurances is becoming essential (Nasir et al., 2020). Furthermore, certain PTEs currently handle both conventional and Islamic investment funds, which has led to the need for assurance that a clear separation between these funds must exist. Although most of these PTEs are not regulated under specific regulators, it is recommended that these PTEs enhance their Shariah governance practices. This includes implementing Shariah audits as a value add to gain confidence from the public on the seriousness of ensuring Shariah-compliant status.

#### *Strategy 2: Developing Specific Shariah Audit Scopes*

With regards to Shariah audit scope, for the Islamic financial sector, the current Shariah audit scope covers thematic audit on new products, Shariah governance, and reporting, embedded the audit scope into ongoing key business, Shariah risk assessment at functional and departmental levels, and structure and system development. Meanwhile, for the ICM sector, the current Shariah audit scope covers audits on the management of securities reclassified as non-Shariah compliant, fund managers managing different asset classes, investment management of Islamic funds, and Shariah advisor's guidance and opinion.

Conversely, the current Shariah audit scope for the Islamic cooperative sector focuses on zakat payment, zakat distribution, *zakat wakalah*, sources of income, funds management, investment activities, contracts, fees, penalties, and *akad* and system. Next, for the public Shariah-based sector, the current Shariah audit scope should involve performance audit and financial statement audit, operation audit, receipt, and distribution of zakat fund and waqf management. Lastly, for the PTE sector, its Shariah audit scope is like ICM when it needs to cover fund managers managing different asset classes, investment management of Islamic funds, and their respective unique establishment mandates.

To improve Shariah audit practices in Shariah-based sectors, it is suggested that regulators for each Shariah-based sector expand their Shariah audit scope as expected by the industry players in these selected Shariah-based sectors. Based on FGD sessions, participants from other than the Islamic financial sector are expecting their institutions to cover a wider Shariah audit scope, including determination, calculation, and disclosure of Shariah non-compliance income, calculation of *ta'widh*, *gharamah* and *ibra'*, Shariah governance reporting and communication, assess the effectiveness of Shariah community in ensuring compliance and zakat calculation and reporting. This is in line with the suggestion made by Mulyany et al. (2021) on the need to widen the existing Shariah audit scopes.

Besides, it is also expected that these other Shariah-based sectors will cover Shariah risk management as part of the auditable area. This is crucial as Shariah risk management must be sound to prevent any Shariah non-compliance events that can lead to direct and indirect losses.

The risk areas covered include financial, operational, compliance, and reputational risk (Khalid et al., 2019). This Shariah risk management scope must focus on adding value and involve critical thinking, investigative, and communication skills, among others.

### *Strategy 3: Enhancing Professionalisation of Shariah Auditors*

The competency of a Shariah auditor is one of the recurring issues highlighted during FGD sessions with Shariah-based sectors. Normally, the competency of Shariah auditors must include Shariah audit knowledge, skills, and related characteristics. The knowledge elements include Shariah and auditing knowledge, whilst the relevant skills required of Shariah auditors are accounting, auditing, and risk management. Meanwhile, related characteristics such as a positive attitude, willingness to learn, commitment, dedication, passion, judgement, strong vision, and ethics have also been identified to be equipped with Shariah audit knowledge and skills (Kamaruddin et al., 2023).

Therefore, it is recommended for these Shariah-based institutions to conduct Shariah audit training programmes to educate Shariah auditors on holistic Shariah audit scope, process (risk-based), and skillset by considering the uniqueness of each Shariah-based sector. This is in the view that each sector has different issues and challenges in implementing Shariah audit practices. Apart from IFIs, Shariah audit training is much required in other Shariah-based sectors to enhance Shariah audit practices.

The training should first focus on developing foundational knowledge of Shariah for Islamic finance, governance, and auditing principles. The next tier of competency should be on developing applied knowledge of accounting and reporting for Islamic financial transactions and Shariah risk management and internal control. Consequently, the third tier of competency should be on developing applied skills in formulating a Shariah audit programme, executing the Shariah audit process, and performing Shariah audit fieldwork. The last tier of competency is developing strategic professional knowledge and skills portrayed in the Shariah audit reporting and communication, and lastly, developing external Shariah audits.

In addition, one of the means to mainstream the Shariah audit profession and maintain the professionalism of Shariah auditors is for a professional association related to Shariah auditors to be established at par with other professional bodies in the industry. This professional association will govern Shariah auditor practices and continuously issue updates and guidelines related to Shariah audit practices for its members. Additionally, to ensure members' competency, members should gather annual attainment of minimum Continuous Professional Development (CPD) points to remain professional Shariah auditors. This is in line with the previous suggestion by Najeeb and Ibrahim (2014) for Malaysia to introduce and lead this Shariah audit professional body.

It is expected that the series of Shariah audit training conducted especially for other than the Islamic financial sector will develop a pool of competent Shariah auditors who are knowledgeable on holistic Shariah audit scope, process (risk-based), and reporting. Thus, this will reduce the gap of the inadequate Shariah auditors in the market at present.

## **CONCLUSION**

This study examines the current Shariah audit practices in several Shariah-based sectors in Malaysia, namely, Islamic financial sector, ICM, Islamic cooperative, public Shariah-based, and PTE. Notably, each Shariah-based sector has different issues and challenges. For instance, the Islamic financial sector faces inadequate knowledge of operational Shariah issues, inadequate training programmes related to internal Shariah audits, and inadequacies in performing risk-based Shariah audits. Meanwhile, the ICM sector has inadequate knowledge of front liners in operational Shariah issues, inadequate internal auditors well-versed with ICM and fund management, and inadequate talent for the appointment of compliance officers or Shariah auditors.

For Islamic cooperatives, among the issues and challenges identified are due to diverse practices as some Islamic cooperatives have internal Shariah committees while others outsource depending on the size of Islamic cooperatives; issue of limited available Shariah scholars to sit as Shariah committees in Islamic cooperatives; and SKM as regulator still in the process to establish their own Shariah functions. In contrast, issues and challenges in implementing Shariah audit by the public Shariah-based sector include the absence of clear Shariah audit scopes, no standard on Shariah compliance guidelines, unstandardised Shariah audit practices among institutions, and shortage of talent in Shariah audit. Finally, for the PTE sector, several issues and challenges were recognised, which are inadequate knowledge of operational Shariah issues, inadequate training programmes related to internal Shariah audits, and inadequacies in implementing risk-based internal Shariah audits.

Based on the findings, a number of strategies were proposed for enhancement in Shariah audit practices in the future. First, nurturing Shariah governance and assurance was proposed, especially for sectors other than the Islamic financial sector, due to the absence of a specific SGF in these Shariah-based sectors. Having a strong Shariah governance practice will lead to the need for Shariah audit practices. Second, developing specific Shariah audit scopes based on the uniqueness of each Shariah-based sector. This strategy is suggested by considering different activities conducted by respective Shariah-based sectors. A wider expansion of Shariah audit scopes covering determination, calculation, and disclosure of Shariah non-compliance income, calculation of *ta'widh*, *gharamah* and *ibra'*, Shariah governance reporting and communication, assess the effectiveness of Shariah community in ensuring compliance, zakat calculation and reporting as well as Shariah risk management. Finally, this study proposed to enhance the professionalisation of Shariah auditors. This can be achieved through Shariah audit training programmes and the establishment of a professional association related to Shariah auditors to mainstream the Shariah audit profession and maintain the professionalism of Shariah auditors.

In constructing the results of this study, certain limitations must be acknowledged. The study is currently limited to the involvement of practitioners' and regulators' points of view. Hence, future studies are recommended to extend to other stakeholders, including the client, beneficiaries, and the public.

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