

Independence and Effectiveness of Internal Shariah Audit: An Islamic Agency Theory

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ABSTRACT

Internal Shariah auditors' effectiveness to Shariah auditing is as important as Shariah compliance to Islamic financial institutions (IFIs) particularly the independence possessed by the internal Shariah auditors themselves. This research is to conceptually examine the relationship between independence and effectiveness of internal Shariah audit based on Islamic agency theory in IFIs. The research propounds that Islamic agency theory could serve as a theoretical foundation to build the conceptual framework on internal Shariah audit effectiveness. In the light of the theory, it was proposed that the effectiveness of internal Shariah audit could be enhanced by it is independent.

Key words: Internal Shariah audit, Effectiveness, Independence, IFIs, Islamic agency theory

INTRODUCTION

The concept's effectiveness has received increasing attention in the literature in recent times. Internal auditors assist management in ensuring that there is a proper internal control system in place and that the operations of the company are carried out efficiently, economically and effectively (Haron, Chambers, Ramsi, & Ismail, 2004). Internal Shariah audit effectiveness helps develop the work of Islamic financial institutions (IFIs) because the financial reports reflect the internal Shariah audit department's quality. The internal Shariah audit department is very important inside an Islamic bank that the internal Shariah audit is regarded as the key element in the application of accounting systems, which in turn, helps in evaluating the work of the department. The internal Shariah audit is considered as the backbone of the business accounting as it is the section that records all businesses related to the sector. It is concerned with advising entities how to achieve their objectives through managing risks and improving internal control. Even though internal Shariah audit is useful in all types of IFIs, much of it is required in the public sector where objectives are usually broad, complex and not easy to measure

Failures of large corporate such as Enron and WorldCom have called for emphasis on internal auditors, resulting in increased need for internal Shariah auditor to monitoring role. This necessitates IFIs to invest in internal auditing and improve the independence of internal Shariah auditor to ensure the achievement of organization objective (Rahman, 2011). This research discusses the impact of internal Shariah audit independence in terms of level of independence, reporting level, direct contact, conflict of interest, interference, unrestricted

access, appointment and removal and performing of non-Shariah audit activities on internal Shariah audit effectiveness based on Islamic agency theory in IFIs. In line with this, the purpose of this paper is to propose conceptual relationship between independence and effectiveness of internal Shariah audit in IFIs

AUDITING FROM ISLAMIC POINT VIEW

Islamic Shariah auditing provides an institution to solicit advice and also to monitor performance so that the IFIs operates as a strictly Islamic concern. The Islamic precepts highlighted the differences between Islamic and Western business practices. For example, the Islamic Shariah prohibits, among other things, the payment and receipt of *riba* or usury (Quran 2: 275-276), gambling (Quran 5:90), hoarding (Quran 9:34) and speculation (Qureshi, 1976). Besides that, Islam also forbids any investing or dealing in alcohol, pork and other activities which are considered unlawful from an Islamic perspective.

The need for Shariah audit stem from the requirement that organization should comply with the Shariah. If internal Shariah auditors find any violation of the Islamic principles in the operation of organization, then this should be reported to Shariah supervisory board (SSB). Islamic or Shariah audit is the examination as per guidance of the Accounting and auditing organization for IFIs (AAOIFI). Shariah audit is an examination of the extent of IFIs compliance, in all its activities with the Shariah. This examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements reports. Since IFIs are supposed to be operating under the Islamic worldview, they may need different types of accounting (Ibrahim, 2000) and auditing system (Khan, 2001). They are expected to serve the needs of Islamic community whose focus and priorities are different from other worldviews (Kasim, Ibrahim, & Sulaiman, 2009).

SHARIAH AUDITING IN IFIS

The establishment of IFIs has resulted in great changes; especially in the way the institutions do their business (Karim, 2001) and objectives (Harahap, 2002), which in turn has affected the audit of these institutions (Karim, 2001). Currently, auditing practice of IFIs in various countries are under their respective local jurisdiction with some adopted fully and others partially the AAOFI's standards. AAOIFI's guidelines on Shariah audit can be considered as the most relevant guideline available for Shariah audit practice. Besides internal Shariah auditors, there are external auditors who are responsible for financial audit; and all IFIs have SSB in-house whose main duty is to certify the adherence of the banks to Shariah principles. Shariah auditing has currently emerged as an important subject of discussion in line with the rapid development of IFIs.

Organization that has effective internal audit function will be much better than those organizational that has not such a function especially in related to fraud, detection and prevention (Corama, 2006; Maria, 2012; Omar & Bakar, 2012). The internal Shariah audit is concerned with sound and effective internal control system for Shariah compliance through continuous periodical assessment (Rahman, 2011). The internal auditor not act only as a player to ensure corporate governance as well as providing internal consultancy (Stewart & Subramaniam, 2010), but the role has been extended to practice Shariah audit in order to ensure that the operations of IFIs are Shariah compliant. The internal Shariah auditor should satisfy himself and formulate accurate judgment that the transactions and controls he

examined during his audit process comply with Islamic Shariah rules and principles (Yahya & Mahzan, 2012).

Shariah audit function is handled by internal audit department of Islamic banks, to be independent an auditor should be able to demonstrate that there is no threat to his independence such that an outsider would not doubt the auditor's objectivity (Arens, 2008; Messier, 2002). Thus, it is suggested that there is a need to have regular independence Shariah auditor in IFIs (Nawal Kasim, Ibrahim, Hameed, & Sulaiman, 2009).

INTERNAL SHARIAH AUDIT EFFECTIVENESS

According to Institute of internal audit (IIA) (2010), effectiveness can be defined as degree including quality to which established objectives are achieved. Bank Negara Malaysia (BNM) (2010) defines effectiveness as objective to ensure a sound and effective internal control system for Shariah compliance. According to AAOIFI (2010) effectiveness is the performance of internal Shariah audit work such as ability to plan, implementation, document information, Shariah audit findings, recommendations, numbers of repeated reports, follow up and evaluation of extent of Shariah compliance with Islamic Shariah rules and principles, Fatwas, guidelines and instructions by the IFI's SSB (AAOIFI, 2010). Badara & Saidin (2013), in their research highlighted a few definitions of the effectiveness term. It means that internal audit effectiveness can be define as the degree to which established objectives are achieved. Most of the researchers agree that a program can be seen as effective if its outcome goes along with its objective (Ahmad, Othman, & Jusoff, 2009; Ussahawanitchakit, 2012). Therefore, from the above definition, this research defined Shariah audit effectiveness or internal Shariah audit effectiveness as the ability of internal Shariah auditors to achieve established objective within IFIs.

Previous studies in Shariah audit have looked into the needs and challenges (Rahman, 2008), perceptions of academicians and practitioners towards Shariah audit (Mulany, 2008), professionalization of Shariah auditor (Shahul, 2013), conceptualizing the duties and rules of Shariah auditors (Othman, et al., 2015) and audit framework for Shariah compliance (Shafii et al., 2010). As well as a few studies done on Shariah audit practices in IFIs focused on the scope, competency, and working practices and current framework used to perform Shariah audit (Kasim et al., 2009; Nik Suliman, 2012; Yahya & Mahzan, 2012). However, internal Shariah audit effectiveness has not been extensively studied compared to studies in external audits and also internal audit in conventional bank. This research will propose the relationship between independence and effectiveness of internal Shariah audit in IFIs. Currently, the Shariah audit and Shariah review process is done internally. The literature review related to internal Shariah audit effectiveness will be adapted from previous literature. Previous research related to internal audit effectiveness are conducted by Ahmad (2009); Arena & Azzone (2009; Badara & Saidin (2014); Endaya & Hanefah (2013); Mihret & Yismaw (2007).

Ahmed et al. (2012) identified lack of training and support from management, lack of employees, and negative perception of management towards the recommended solutions given by the internal auditors as factors that affect the effectiveness of internal audit in Malaysian public sector.. In addition, the study found that internal audit effectiveness relates to understanding the stakeholders' expectations towards the performance of an organization. It is found that the internal audit function could deliver an effective performance of internal audit when the internal auditors understand the expectations of board of directors, CEO, and operating management in the institutions (Feizizadeh, 2012). Effective internal Shariah auditor professionals have the following characteristics: the ability to align the structure of

internal Shariah audit with the dynamics of the Islamic banks operations; there should be strong relationship between management skills for maintaining appropriate and SSB needs and expectations. Beside the above, the level of training, education, experience as well as professional qualifications of the internal auditors influenced the effectiveness of internal audit (Al-Twajry, Brierley, & Gwilliam, 2003).

IFIs especially Islamic banks are showing concerned to their internal Shariah audit in order to ensure the effectiveness of Shariah compliance in which in turn can contribute to positively to the Ummah (society) at large (ISRA, 2013). Therefore, IFIs with effective and efficient internal Shariah audit function are more than those that have not such a function to detect fraud within their organizations. Hence, an effective internal Shariah auditor is the one who assist IFIs in meeting their objectives; therefore, IFIs should ensure that their internal Shariah audit is effective to create value and effectiveness in such organization.

From the author's review of literature, there is no study that has been conducted to examine independence based on an Islamic agency theory that contribute to the effectiveness of internal Shariah auditors in IFIs Interpersonal skills, internal auditor's commitment and support from audit committee and BOD, audit performance and integrity, audit department efficiency, auditing competencies, internal auditor's knowledge on company's business operation and industry and auditor independence are found to be important attributes contributing towards internal audit function effectiveness (Nasibah, Othman, Othman, & Jusoff, 2009). An effective internal Shariah auditor assists in adding value and improves the performance of IFIs. Based on the approaches of previous research (e.g., Al-Twajry, Brierley & Gwilliam 2003; Arena & Azzone 2009; Cohen & Sayag 2010; Mihret, James & Mula 2010; Mihret & Yismaw 2007).

INDEPENDENCE IN SHARIAH AUDIT

As a new emerging discipline, there are several issues which need to be resolved in order to develop a sound Shariah auditing system for IFIs (Sundararajan & Errico, 2002). One of such issues is internal Shariah auditor independence (Nawal Kasim & Sanusi, 2013). Independence in auditing means taking unbiased viewpoint in the performance of audit tests, the issuance and the evaluation of the results of report (Arens, 2008) that management can place full reliance on audit findings and recommendations (Pickett, 2010). Independence requires both (i) independence of mind and (ii) independence in appearance (MIA, 2006). Mautz and Sharaf (1961) defined independence in fact or actual independence as the auditors' state of mind and his/her ability to maintain a proper attitude in the planning of his audit program. On the other hand, independence in appearance or perceived independence refers to the publics or others, perceptions of the auditor's independence. An internal Shariah auditor should be able to demonstrate that there is no threat to his or her independence, and then only his/her independent can be seen. Independence is a critical issue in auditing since it is the cornerstone of the profession (Mautz & Sharaf, 1961).

Independence is achieved through the organizational status of internal audit and the objectivity of internal auditors (Murtuza & Abdallah, 2007). All the outcome of Shariah audit function listed to the Shariah supervisory board (SSB) may engage independence issues since the SSB of IFIs is responsible in decisions, opinions related to Shariah matters. Shariah auditor must maintain a high level of independence to keep the confidence of users relying on their reports, the internal Shariah auditor must report directly to the board of directors and audit and governance committee (AGC) to ensure independent from the operating unit they audit. The Shariah Governance Framework (SGF) issued by BNM (2011) requires that the responsibility of conducting Shariah audit lies in the hands of the internal audit unit. It

indicates that the responsibility of internal Shariah auditor has expanded his scope of work to perform Shariah audit in ensuring that the operations of the IFIs (IFIs) are Shariah compliant (Shafii, Salleh, Hanefah, & Jusoff, 2013)

The independence of internal Shariah auditor plays a crucial role in effective discharge of his duties and profession. He occupies a unique position, as he appointed by the management but also review the conduct of the same management, which potentially places him in a position of conflict and thus his independence while conducting his work. This gives significant tension to the internal auditor as he does not find himself independent from the management (Agarwal & Medury, 2014). Without independence, the internal auditor simply becomes a part of the management team, losing the ability to offer a fresh perspective through an objective evaluation (Flesher & Zanzig, 2000) An auditor is essential to be independence in both fact and appearance. However, Mautz and Sharaf (1961) delineated independence to be “(1) real independence of the individual practitioner in his performance of his work; (2) and second, the apparent independence of auditors as a professional group”. Independence is the cornerstone of the auditing profession, without independence the auditor’s opinion is suspect. In case of independence, the Shariah auditors’ integrity are further promoted by the stakeholders in IFIs for the Shariah auditors to be independence enough to give opinions on the situations of IFIs in the term of Shariah compliance in all its portions.

The literature on internal audit independence pinpoints three factors that significantly contribute to the degree of auditor independence 1) Clear definition of the auditor’s responsibility 2) The position of the internal auditor within the institution’s organizational structure, and 3) The reporting structure (Uddin, Ullah, & Hossain, 2013). In real practice, a heavy dependence on internal Shariah auditors or the management of the Shariah unit is placed to carry out Shariah audit in Islamic financial institutions (IFIs). No clear separation of duties been determined, this will lead to self-review may occur (Kasim et al., 2009). This lead to full potential of an audit cannot be realized if they are not wholly and truly independent, as the social purpose (benefit to the Ummah) will be frustrated.

According to Rahman (2008) Shariah auditor is independent whether he/she individual practitioners or members of public accounting firm who render professional auditing services to clients. By virtue of his/her education, training and experience, independent auditor is qualified to perform the audit work. To be independent, auditor should be without bias in respect of client under audit and should appear impartial to those relying on the results of the audit. This research will explore the conceptual influence of independence to the effectiveness of internal Shariah audit in light of Islamic agency theory the elaboration of which will be given in the next succeeding sections.

INDEPENDENCE AND EFFECTIVENESS OF INTERNAL SHARIAH AUDIT IN LIGHT OF ISLAMIC AGENCY THEORY

An agency theory defines a contract under which one or more persons (principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent (Jensen & Meckling, 1976). Agency problem is more intense in the case of IFIs as while investors in conventional banks have a level of certainty in their returns, in Islamic banks the profit as well as possible incurred loss and consequently the risk is shared between the banks and its investors (Siddiqui, 2001).

Thus, according to Safieddine (2009), the issue in IFIs is not limited to the separation of ownership and control, but extends to the separation of cash flow and control which makes the agency problem in IFIs more complicated than conventional banks. From the very

beginning Islam emphasizes on the importance of relationship, any relationship given in this world especially for Muslim people should begin with the relationship with Allah s.w.t. As mentioned in the Quran “Behold a host of gathered against you, so beware of them-whereupon this only increases their faith, so that they answered, God is enough for us; and how excellent a guardian is He”. Relying on faith through building a concrete relationship with Allah s.w.t, this would also determine a good relationship with other humans and other living things in this world. In Islamic economics field, the relationship with others may exist between e.g. the capital provider (rabbul mal) and entrepreneur (mudarib), among capital providers or partners, buyers and seller, agent (wakeel) and principal (muwakkel), contractor (wakif) and beneficiaries (muawikif), pledge (marhun) and assets owner (murtahin). Generally, this relationship creates a principal-agent relationship, several researchers have explores the Islamic economics as a field in relation to the principle-agent relationship (Ghafar b. Ismail & Tohirin, 2010; Pratomo & Ismail, 2006; Sarker, 1999; Umer & Habib, 2002). Since our lives must be guided by Tawhid, hence, this study can use Tawhid epistemology as the guiding principles in Islamic agency theory. Unity, Khalifah, (vicegerent), Ihsan are the principles basis of the agency theory in Islam. The agency problems can be reduced through the concept of unity which means cooperation and participation in the organization which does not exist in the conventional agency theory (Shamsuddin & Ismail, 2013). Our social life or business activities cannot be done without instilling the concept of unity. Thus the internal Shariah auditors in Islamic-oriented agency relationship have to apply Islamic Shariah rules and principles that issues by AAOIFI as well as Fatwas and guidelines issues by Shariah supervisory board.

Khalifah (vicegerent) and Ihsan reflect well the agency theory relationship. As information asymmetry becomes one agency problem, where the principal (muwakeel) does not have the ability to access the entire agent’s (wakil) information, so that, no such information asymmetry is assumed when both parties are engaged in a relationship with Allah. An agent (wakil), knows that they have an obligation to provide for the best interest of the principals (muwakkel). Both parties believed that Allah has the perfect knowledge and each of their action will be accountable in the hereafter, therefore, each of their actions and decisions has to realign with the clearly codified agency contract (Shamsuddin & Ismail, 2013).

The Islamic agency theory teaches us partnership members to practice respect, gratitude, patience, tolerance and also to believe not only in the economic reward/outcome as in the conventional agency theory but also in spiritual rewards (blessings from Allah). The practice of lying, shirking, conceit and jealousy must be avoided by each party. This acquires continuous Islamic teachings and training to the partnership member for them to be educated with spiritual knowledge. Islam recognizes the knowledge process of each individual, seeking knowledge is a continuous process in Islam. Furthermore, the spreading of knowledge has been encouraged by the Prophet Mohammed (p.b.u.h). “Allah illuminates a man who hears hadith from me preserves it carefully and passes it on to other”.

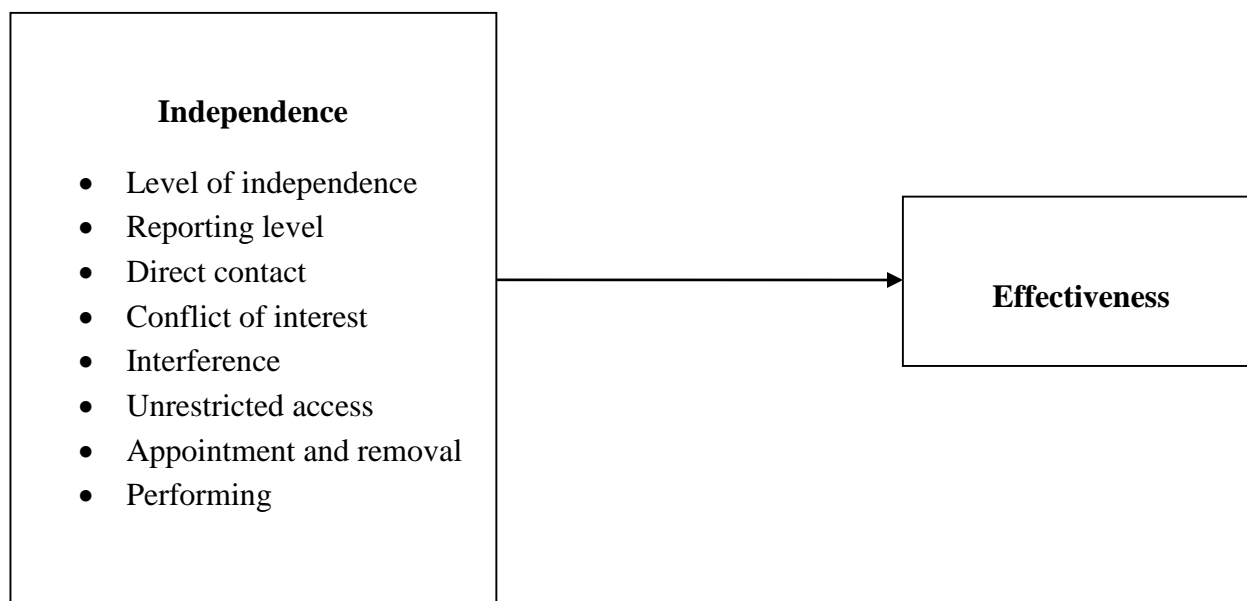
Therefore, it is crucial to implement the Islamic training which emphasizes on the importance of knowledge, individual development and ethical –oriented practices in the organization. Such it can be stated that the Islamic agency theory uses the Quran and Hadith to determine the features and framework of the economic relationship practices in IFIs, the development of the Islamic economic system will be successful when Islamic agency theory practices.

CONCEPTUAL FRAMEWORK

As a theory, Islamic agency has several concepts. This research extends the original concepts of the theory to the topic under study.

Basing on the discussion in the preceding sections and in line with the explanation of the theory with regard to the conceptual relationship between independence and effectiveness of internal Shariah audit, the following conceptual framework is developed (Figure 1) and corresponding propositions are consequently formulated.

Figure 1: Conceptual Framework of Relationship between Independence and Effectiveness of Internal Shariah Audit in the Light of an Islamic Agency Theory



PROPOSITION

Internal Shariah auditors with independence possess different kind of unique knowledge competencies, capabilities and skill as a result of length of tenure on the job practice in the auditing professions which enhance their efficiency and effectiveness (Mihret & Yismaw, 2007) via developing the knowledge bases of the unique risks – Shariah incompliance; and audit approaches for IFIs. Audit independence enable internal Shariah audit to provide good Shariah audit results as well as good recommendation. Additionally, the independence enhance the effectiveness of internal Shariah audit abilities to possess the discipline, knowledge and skills essential to the effectiveness of internal Shariah audit, proficiency in Islamic Shariah rules and principles in general, and Fiqh al-muamalat in particular (AAOIFI, 2010). Internal Shariah auditors with level of independent can make a right decision, decide fast and deal with any situation. Expert individuals' internal Shariah auditor help in IFIs growth because they have a clear insight about how to deal with process and accomplish their tasks with superior quality.

Islamic agency theory informs that having all of these independence (level of independence, reporting level, direct contact, conflict of interest, interference, unrestricted access, appointment and removal and performing) help the internal Shariah auditors to achieve effectiveness by taking unbiased viewpoint in the performance of audit tests, the issuance and the evaluation of the results of report (Arens, 2008) that management can place

full reliance on audit findings and recommendations (Pickett, 2010). In other words, the internal Shariah auditors show (i) independence of mind/in fact or actual independence and their ability to maintain a proper attitude in the planning of the audit program and (ii) independence in appearance/perceived independence or public or others' perceptions of the auditor's independence (Mautz & Sharaf, 1961). Here, they have achieved independence - objectivity and organizational status (Murtuza & Abdallah, 2007). Thus the following hypothesis are postulated:

H 1: The higher the independence the higher the effectiveness of internal Shariah audit in IFIs

H1a: Level of independence of internal Shariah audit independence will have positive impact on internal Shariah audit effectiveness.

H1b: Reporting level of internal Shariah audit independence will have positive impact on internal Shariah audit effectiveness.

H1c: Direct contact of internal Shariah audit independence will have positive impact on internal Shariah audit effectiveness.

H1d: Conflict of interest of internal Shariah audit independence will have positive impact on internal Shariah audit Effectiveness.

H1e: Interference of internal Shariah audit independence will have positive impact on internal Shariah audit effectiveness.

H1f: Unrestricted access of internal Shariah audit independence will have positive impact on internal Shariah audit effectiveness.

H1g: Appointment and removal of internal Shariah audit independence will have positive impact on internal Shariah audit effectiveness.

H1h: Performing Non-Shariah audit by internal Shariah audit independence will have positive impact on internal Shariah audit effectiveness.

DISCUSSION AND CONCLUSION

The research explores the conceptual relationships between independence and effectiveness of internal Shariah audit in IFIs based on Islamic agency theory. Existing literature review shows limitation of studies on effectiveness of internal Shariah audit related to independence of internal Shariah audit in IFIs. This research in a way is an effort towards adding more literature on the subject under study and contributing towards a better understanding on the effectiveness of internal Shariah audit in IFIs which requires different set of human capital. This research propounds that Islamic agency theory could be used in building a conceptual framework on impact of independence on effectiveness of internal Shariah audit.

Effectiveness could be enhanced by more independent internal Shariah audit independence as part of Nature in Islamic worldview should be utilised to make Shariah auditing related decisions effectiveness. Thus, it was further proposed that the higher independence the higher effectiveness of internal Shariah audit in IFIs. As this is a conceptual research, the proposed conceptual framework needs to be verified empirically.

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