INTERNAL CONTROL SYSTEM AND EFFECTIVE INTERNAL SHARIAH AUDIT FUNCTION: A CONCEPTUAL FRAMEWORK

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ABSTRACT

This study proposes a conceptual framework for the internal control system, as a necessary prerequisite for an effective internal Shariah audit function in Islamic Financial Institutions (IFIs). To improve a strong management of risks that do not comply with the Shariah, it is imperative that the internal Shariah audit function is effectively operated. This study reviews existing literature on the internal Shariah audit function. By adopting contingency theory, this study then develops a conceptual framework for an effective internal Shariah audit function. The main argument presented in this article is that a strong internal control system leads to a more effective the internal Shariah audit function at managing risks associated with non-compliant events in IFIs. This study contributes to provide a clear direction to the IFIs in reshaping the prevailing Shariah audit function and Shariah governance arrangements.

Keywords: Shariah Audit, Shariah Governance, Shariah Non-Compliance Risks, Internal Control System, Contingency Theory.

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INTRODUCTION

Effective operation is typically associated with the extent to which a group of individuals in an organisation achieves the intended goals. The achievement of effective internal audit is crucial to enhance the robustness of internal processes and maintain stakeholders’ confidence. As a third line of defence, the internal audit function offers objective assurance on the strong governance and control mechanisms established by the organisation in managing potential risks in its business activities (Institute of Internal Auditors (IIA), 2010). In the context of Islamic Financial Institutions (IFIs), internal audit division performs the Shariah audit function (Bank Negara Malaysia, 2019). Hence, the effectiveness of the internal Shariah audit function can be defined as the ability to fulfil the role of providing objective assurance on the strong governance and control mechanisms established by the IFIs. The control function must be effective to manage the potential risks of Shariah non-compliance in their business operations.
Shariah compliance plays a crucial role in the business operations of IFIs and should not be underrated. This is due to the fact that Islamic finance industry contributes a remarkable share of the overall financial system in Malaysia (Bank Negara Malaysia, 2023) and 18.4% Malaysian market share of the total global Islamic financial assets as at 2020 (Bank Negara Malaysia, 2022). Hence, the remarkable growth in IFIs including Islamic banking and Takaful operations must conform to the tenets of Shariah law. In the era of modern meta-verse and digital technologies, IFIs may face the challenges to set up a reliable Shariah control functions and continue to provide an advance value-based Islamic financial services to the stakeholders.

After the issuance of Shariah Governance Policy Document (SGPD) in 2019, which supplements the Shariah Governance Framework (SGF) issued in 2010, IFIs have been asked to revise their approaches in conducting an effective arrangement of Shariah governance (Bank Negara Malaysia, 2010; 2019). The IFIs need to develop and strengthen the control functions in managing the operational and Shariah non-compliance risks (Bank Negara Malaysia, 2019). To effectively manage Shariah non-compliance risks, IFIs must therefore conduct a thorough evaluation of the internal and external factors that impact the performance of the control functions. In this respect, Shariah audit is one of the significant control functions to ensure Shariah compliance apart from Shariah review and Shariah risk management function.

The implementation of Shariah audit process requires a structured Shariah audit methodology (Abdul Rahman, 2011). This will assist the internal Shariah auditors in evaluating the risks related to Shariah non-compliance in IFI’s business operations. It is crucially imperative for IFIs to guarantee impartial adherence to Shariah principles and minimise Shariah non-compliance risks. To effectively manage the Shariah non-compliance risks, several crucial factors must be taken into consideration. These include the incorporation of Shariah audit into governance structure, ensuring the competence of internal Shariah auditors, following appropriate Shariah audit procedures and fulfilling reporting obligations (Ab Ghani, Mohd Ariffin and Abdul Rahman, 2022).

Previous studies have identified a number of determinants that affect how effective it is of an IFI’s internal Shariah audit function. The aforementioned factors comprise of independence, competency, the involvement of Shariah Committee members, the Shariah audit procedure and top management endorsement, among other internal and external factors (Algabry et al., 2020; Khalid et al., 2017). However, limited studies have identified internal control system as a critical factor that influence the extent of effective internal Shariah audit function in IFIs. In other type of organisation, previous studies observed the significance of internal control system as the foundation of an effective internal audit function (Badara and Saidin, 2014; Vijayakumar and Nagaraja, 2012).

Undeniably, it is crucial to conduct a comprehensive evaluation of internal control systems as a fundamental component of the internal Shariah audit function. This is imperative in order to improve the management of Shariah non-compliance risks. Disregarding the importance of this theoretical investigation would diminish the ability of IFIs to effectively address and mitigate these risks. The main objective of this research paper is to propose a conceptual framework showing the contingent effect of internal control system on the effectiveness of internal Shariah audit function in IFIs. Through a more comprehensive understanding of internal control system as a crucial antecedent, the Islamic finance sector and regulatory entities can fortify and enhance current regulatory mandates, such as the Shariah governance and Shariah audit frameworks. The aforementioned proposal has the potential to enhance the efficacy and inclusivity of measures aimed at ensuring adherence to regulations and mitigating of potential risks related to Shariah non-compliance within the domain of Islamic finance.
Next section describes the regulatory requirements related to the Shariah Governance Framework and internal control system followed by the literature review on the effectiveness of the internal Shariah audit function. The subsequent part presents the conceptual framework to incorporate the contingency theory in formulating the hypothesis. The study finally concludes this research and outlines the directions for future research.

**SHARIAH GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS**

The significant growth of IFIs across different nations has garnered considerable attention and witnesses a surge in the demand from stakeholders for Islamic financial products and services. Consequently, it is of the utmost importance that IFIs ensure compliance with Shariah principles as well as the risk management and governance in their daily operations and business activities. Regulators in Malaysia and the Middle East have demonstrated a tremendous amount of support for the issuance of strict rules and guidelines relating to Shariah governance. Therefore, it is crucial for the IFIs to ensure that their operations and business activities comply with the Shariah principles. This will increase the stakeholders’ significant trust and confidence towards the IFIs.

In Malaysia, the Shariah Governance Framework (SGF) was first issued by Bank Negara Malaysia (BNM) in 2010 to be complied by all IFIs. Structures, methods, activities and business operations are all required to be Shariah compliant, as per SGF’s regulations for IFIs (Bank Negara Malaysia, 2010). SGF has emphasised the roles of the Board of Directors, members of the Shariah Committee and management in performing overall Shariah oversight and executive positions in IFIs. For this reason, IFIs must establish specific functions related to Shariah compliance i.e. Shariah audit function, apart from Shariah review and Shariah risk management. The role of these Shariah compliance functions is to guarantee that all their processes and procedures, as well as their commercial operations, adhere to Islamic law (Bank Negara Malaysia, 2010).

After 10 years, the SGF is superseded by the Shariah Governance Policy Document (SGPD) issued by BNM in 2019 for all IFIs in Malaysia (Bank Negara Malaysia 2010; 2019). A review on the recent SGPD reveals a significant improvement in comparison to the previous requirements outlined in SGF. The improvements primarily concentrate on strengthening the oversight responsibilities of the Board, members of Shariah Committee and control functions within the Shariah governance structure in IFIs (Bank Negara Malaysia, 2019). Additionally, this research recognises the significance of IFIs in fostering a culture that gives precedence to Shariah compliance risks. This requirement emphasises the critical importance of the Board, Shariah Committee members and the top management in actively participating and resolving issues pertaining to non-compliance with Shariah principles (Bank Negara Malaysia, 2019). The SGPD has emphasised the significance of the control function for Shariah compliance in effectively mitigating the risks of Shariah non-compliance in IFIs. In addition, the SGPD emphasised the significance of a robust internal Shariah audit framework that assesses the control function, risk-control processes and adherence to Shariah principles in the operational activities of IFIs (Bank Negara Malaysia, 2019). BNM has now emphasised on the crucial needs of having a well-functioning and Shariah compliant internal control system in IFIs.

On the other hand, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) based in Bahrain has issued the Governance Standard for IFIs with the objective of establishing a systematic guidance in ensuring compliance to Shariah rules and principles in all Islamic financial dealings and transactions (Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), 2020). The Shariah Supervisory
Board (SSB), Shariah review function, Audit and Governance Committee and Shariah compliance function are all responsible for achieving Shariah compliance, according to the Governance Standards for IFIs. The establishment of a Shariah compliance function in IFIs, as mandated by AAOIFI, plays a vital role in emphasising management responsibilities and establishing a transparent reporting structure to ensure Shariah compliance at all levels. AAOIFI has also developed a framework for an internal Shariah audit function, aimed at assisting IFIs in carrying out Shariah audits (AAOIFI, 2020).

Based on the above requirements and guidelines, this study acknowledges that IFIs are mandated to ensure Shariah compliance is embedded in every aspect of business operations and activities. Apart from the product development, processes and procedures, the human resource policy, organisational structure, internal control system and accounting system also need to comply with the Shariah principles. This indicates that all organs of the Shariah governance structure in IFIs should establish an effective working relationship. It is imperative that IFIs implement effective Shariah governance arrangement that integrates a systematic and strategic approach, facilitating the assignment and coordination of achieving the Shariah compliance objectives at all levels. An effective working relationship between all organs of the Shariah governance structure in IFIs is demonstrated in the Three Lines of Defence model as highlighted by the Institute of Internal Auditors (2020).

The Institute of Internal Auditors (2020) presents a framework entitled “Three Lines of Defence Model” to describe the interrelationships among senior management, internal control, risk management and internal audit within an organisation. These key functions play different roles and responsibilities in each line of defence to achieve the organisational objective being set by the governing body in the organisation i.e. the Board of Directors (Institute of Internal Auditors, 2020). Likewise, BNM mandates the Board of Directors in IFIs to be responsible for overseeing the establishment of adequate structures and processes to ensure an efficient Shariah governance arrangement (Bank Negara Malaysia, 2019). The responsibility to achieve the Shariah compliance objective in IFIs’ business operations is delegated to the management as the first line of defence. The management performs the Shariah management’s role and maintains appropriate control functions to ensure the Shariah review and Shariah risk management are in place. The first line of defence role is important in directing every activities and resource allocation are dealt in accordance to the Shariah principles. Once the internal control measures are in place for Shariah management, the Shariah review and Shariah risk management take the responsibility as the second line of defence in performing the Shariah compliance review. In this respect, the Shariah risk management is responsible to develop, implement, monitor and report any events that could possibly lead to Shariah non-compliance risks in IFIs’ business operations and activities. Simultaneously, the Shariah review performs periodic evaluations to ensure that all aspects of the business activities of IFIs adhere to the principles and prerequisites of Shariah (Bank Negara Malaysia, 2019). Then, Shariah audit plays the third line of defence role in providing the Shariah audit and assurance. The internal Shariah auditors conducts independent assessment on the business operations to ensure all Shariah principles are complied with. The Shariah audit findings will be communicated to both the Board of Directors and senior management. Once evaluated and agreed by the Board of Directors and Shariah Committee members, objective assurance of Shariah compliance within IFI’s business operations will be reported in the annual report of the IFIs (Bank Negara Malaysia, 2019). This will ultimately enhance the confidence of IFI’s stakeholders.
LITERATURE REVIEW

One of the earliest studies conducted by Mohamad Puad (2014) focused exclusively on the Malaysian Takaful business in order to ascertain several elements that contribute positively to the effectiveness of the Shariah control functions. The elements listed in the study encompass adequate training, a strong internal control system and substantial audit experience. Mohamad Puad (2014) suggests that by addressing these elements, it is possible to improve the overall performance of the Shariah compliance functions.

The impact of several criteria, such as independence, competency and the role of the Shariah Committee members, is believed to have significant influence on the effectiveness of the internal Shariah audit function. Khaled and Sarea (2018) argued that the evaluation of Shariah auditors’ independence is contingent upon several criteria, including but not limited to the extent of reporting, independence, potential conflict of interest and interference as well as unrestricted access to the available resources and direct communication with the relevant parties for Shariah audit purposes. In addition, the competence of internal Shariah auditors is evaluated based on their expertise, due diligence, aptitude, education and practical background (Khalid, Haron and Masron, 2018). A direct communication between the internal Shariah auditors and the Shariah Committee members also helps in establishing an effective internal Shariah audit function as argued by Khalid, Haron, Sarea et al. (2018). The Board of Directors does not have a direct communication with the internal Shariah audit function. Due to information asymmetry, the effectiveness of internal Shariah audit function in IFIs has been influenced by the oversight role played by the Shariah Committee members (Khalid, Haron, Sarea et al., 2018).

Moreover, current studies in internal auditing indicated that various factors, such as top management support, Shariah audit process and organisational independence are deemed crucial determinants for the effectiveness of an internal audit practices in organisation (Roussy, Barbe and Raimbault, 2020; Turetken, Jetherfer and Ozkan, 2020). Zakaria et al. (2019) also argued that the factors influencing the effectiveness of the internal audit function may also influence the effectiveness of the Shariah audit function, as the latter is currently performed by the internal audit division in IFIs.

A recent scholarly article by Algabry et al. (2020) proposed a set of internal and external variables that contribute to the effectiveness of the internal Shariah audit function within Islamic banks (IBs). Among the external circumstances include the regulatory framework governing Islamic banking, the support from the Board of Directors and management, the involvement of external auditors and internal Shariah auditors as well as the perceived factors within the IBs (Algabry et al., 2020). In addition, the Shariah audit function also needs a comprehensive Shariah audit framework. This Shariah audit framework encompasses the structure and guidelines adopted by the internal Shariah auditors, in conjunction with the internal Shariah audit charter developed by the IBs (Algabry et al., 2020). Furthermore, the research emphasises the importance of IFIs in ensuring that their internal Shariah auditors adhere to the fundamental requirements such as objectivity, independence and competence. These requirements are crucial for establishing a robust internal Shariah audit process.

Table 1 summarised the list of papers that provides a complete overview of previous research on the factors influencing the effectiveness of the internal Shariah audit function in IFIs.
Table 1: Previous research on the determinants of an effective Internal Shariah Audit

<table>
<thead>
<tr>
<th>Authors</th>
<th>Determinants</th>
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<tbody>
<tr>
<td>Mohamad Puad (2014)</td>
<td>Training and development Internal control system Experience in auditing</td>
</tr>
<tr>
<td>Khalid, Haron and Masron (2018); Khalid, Haron, Sarea et al. (2018); Khalid and Sarea (2018)</td>
<td>Independence Competency Role of the Shariah Committee members</td>
</tr>
<tr>
<td>Zakaria et al. (2019)</td>
<td>Support from top management Process of Shariah audit Independence of organisation</td>
</tr>
<tr>
<td>Algabry, Alhabshi, Soualhi and Aleddin (2020)</td>
<td>Perceived factors within IBs Regulatory framework Board of Directors Management support External auditors and external Shariah auditors</td>
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Based on the above literature, the study argued on the importance to evaluate the effects of internal control system on the effectiveness of the internal Shariah audit function in IFIs.

CONCEPTUAL MODEL

This paper examines the effects of internal control system on the effectiveness of the internal Shariah audit function in IFIs. The components of internal control system consist of (1) control environment; (2) risk assessment; (3) control activities; (4) information and communication; and (5) monitoring activities as illustrated in Figure 1.

**Figure 1: Conceptual Framework**

The conceptual framework proposed that there is a positive effect of internal control system on the effectiveness of the internal Shariah audit function. This study suggests that the model needs to be evaluated further through regression analysis to determine the component of internal control system that provide the most significant effects towards the effectiveness of the internal Shariah audit function.
Previous studies found a significant and positive correlation between the effectiveness of an organisation’s internal control system and its internal Shariah audit function. The establishment of the internal control system has been argued to have a significant correlation with the effectiveness of the internal audit function (Badara and Saidin, 2014; Hassan, Rahmat and Muhammad Mohamed, 2015; Karagiorgos et al., 2011). Within the realms of public sector organisations and local government, prior empirical research has placed significant emphasis on the significance of the internal control system as a contingent factor for an effective internal audit function (Badara, 2017; Krishnamoorthy, 2002). The establishment of an effective internal control system facilitates the management of Shariah non-compliance risks that could possibly arise during business operations in IFIs.

This study adopts the contingency theory to explain the conceptual framework. Contingency theory asserted that department effectiveness, which encompasses factors such as productivity, supportive relationships and adherence to workgroup norms, is subject to the influence of both internal factors i.e. interdependence and external factor like environment (Hayes, 1977). Otley (1980) emphasised that the identification and establishment of key contingent variables is imperative for the effectiveness of management accounting system. The contingency theory operates on the fundamental principle that “there is no universally appropriate control system that applies in all circumstances” (Fisher, 1995: 24). As a consequence, the effectiveness of an organisation is highly subjected to various contingent factors such as the organisation’s nature and structure (Pennings, 1975). The effectiveness of organisation, in general, is dependent on a variety of contingent elements, including environment, organisational theory, organisational structure and technology (Fisher, 1995; Hayes, 1977; Otley, 1980; Waterhouse and Tiessen, 1978). In a nutshell, studies conducted by Chenhall (2003) and Otley (2016; 2018) indicated that organisational structure serves as a crucial contingent factor in establishing the relationship between the independent and dependent variables. To establish an effective organisational functioning, it is crucial to achieve a suitable alignment between these contingent variables as emphasised by Drazin and Van de Van (1985).

Internal Control System

Chambers, Selim and Vinten (1987) highlighted that internal control system can be one of the contingent factors to influence the organisation’s operational efficiency, the financial reporting reliability and adherence to legal requirements. The internal control system in organisations was assessed through an evaluation that considers contingency attributes, including but not limited to size, strategy, organisation structure and the perceived level of environmental uncertainty (Jokiipi, 2010; Moeller, 2014). One of the ways to assess the effectiveness of an internal control system is by adopting the Internal Control Framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 2013. Moeller (2014) highlighted that the COSO Internal Control Framework (COSO ICF) comprises of five (5) components: the control environment, risk assessment, control activities, information and communication and monitoring activities. According to a study conducted by O’Leary, Iselin and Sharma (2006), the presence of an inadequate internal control system has had a significant impact on the operational structure of an organisation, primarily as a result of a deficient control environment. Moreover, Lansiluoto, Jokiipi and Eklund (2016) stressed that organisation will finally operate an ineffective internal control system if it includes any non-compliance issues in its financial reporting.
In the context of IFIs, Bouheraoua and Djafri (2022) stressed the significance of adopting the COSO ICF in establishing an effective Shariah compliance function and perform robust management of Shariah non-compliance risks. The internal control system holds significant importance within IFIs, as it assumes a central role in shaping the framework of business operations. It establishes the structure for Shariah governance, empowers management teams, formulate Shariah policies and facilitates operations aimed at achieving Shariah compliance objectives. According to Bank Negara Malaysia (2019), the SGPD mandates that IFIs must establish the control function. The control function which include the Shariah audit function is responsible for conducting a periodic assessment in IFI’s business operations. As a consequence, objective assurance is provided to ensure the soundness of the internal control system in relation to Shariah compliance. The implementation of a robust internal control system is of utmost importance in order to minimise instances of non-compliance with Shariah principles within IFI’s business operations. Shafii and Salleh (2010) found that IBs in Bahrain and Malaysia have adopted an internal control system that aligns with the COSO ICF. Through the implementation of a robust internal control system, IFIs can ensure the establishment of effective business operations, precise financial reporting and compliance with Shariah principles and resolutions governing their business operations. However, if internal control system is ineffective, it could indicate that there is an occurrence of fraudulent activities in banking operations (Olatunji, 2009).

This study proposes that internal control system could be a significant factor that influence the ability of IFIs to establish a robust management of Shariah non-compliance risks. By establishing an effective internal control system, an effective internal Shariah audit function can be achieved. Consistent with the observations made by Chenhall (2003), the organisational structure i.e., an effective internal control system in IFIs is regarded as a critical contingent factor that influences the effectiveness of internal Shariah audit function in IFIs. In line with the contingency theory emphasised by Drazin and Van de Ven (1985), IFIs must prioritise the structure of their control function and internal control system within the Shariah governance arrangement. As a consequence, it is expected that IFIs will improve their ability to manage risks related to non-adherence to Shariah principles as required by SGPD (Bank Negara Malaysia, 2019).

The COSO ICF can be adopted as a fundamental tool for evaluating the internal control system. This framework is composed of five (5) essential components, namely the control environment, risk assessment, control activities, information and communication and monitoring activities (COSO, 2013). In accordance with the framework described previously, Table 2 provides an additional breakdown of the 17 principles of internal control system. These principles are distributed among the five (5) interrelated components of internal control system. Based on Moeller (2016), the achievement of an effective internal control system in an organisation requires the incorporation of all five (5) components. The COSO ICF is commonly adopted by IFIs as a framework to develop a robust internal control system. This is important to ensure the adherence of IFIs to Shariah principles in their business activities (Bouheraoua and Djafri, 2022; Shafii and Salleh, 2010).
Table 2: Components and Principles of the COSO Internal Control Framework

<table>
<thead>
<tr>
<th>Components</th>
<th>Principles</th>
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| Control Environment      | 1. Demonstrate commitment to integrity and ethical values  
2. Ensure the Board exercise oversight responsibility  
3. Establish structure, reporting lines, authorities and responsibilities  
4. Demonstrate commitment to attract, develop and retain competent people  
5. Hold people accountable for internal control |
| Risk Assessment          | 6. Specify clear objectives related to risk management  
7. Identify and analyse risk to achieve objectives  
8. Consider potential for fraud risk  
9. Identify and assess significant changes that affects internal controls |
| Control Activities       | 10. Identify and develop risk-mitigation activities  
11. Select and create general IT controls  
12. Develop reliable policies and procedures |
| Information and communication | 13. Obtain, generate and use quality information for internal control function  
14. Communicate internal control information to internal parties  
15. Communicate internal control information to external parties |
| Monitoring Activities    | 16. Conduct ongoing and/or separate evaluations of internal controls  
17. Evaluate and communicate internal control deficiencies to relevant parties |

Source: Moeller (2016)

Based on the literature, it indicates that internal control system is an important contingent factor that could affect the effectiveness of the internal control system in IFIs in Malaysia. Hence, the following hypothesis is proposed:

H1: There is a positive effect of internal control system on the effectiveness of the internal Shariah audit function.

Additionally, COSO ICF needs to be modified so that the context of the components and principles will be closely correspond with the distinctive features of the business operations in IFIs. Furthermore, it is imperative that the measurement employed to evaluate the effectiveness of the internal control system conforms to the regulatory requirements issued by the policymakers in the pertinent jurisdictions.

Control Environment

According to the Klamm and Watson (2009), the establishment of a strong control environment that fosters positive and influential leadership is a crucial component to the implementation of effective internal control system. The internal control system plays a crucial role in determining the organisational structure, outlining the organisational hierarchy, delegating the management responsibilities, setting the policies and objectives as well as executing daily operations within business activities (Root, 1998). Contingency theory highlights the importance of having a control environment that can be adjusted to suit the unique conditions of the organisation (Otley, 1980). It is important to acknowledge that the control environment’s cultural and
structural elements may need to differ depending on factors such as industry, size and organisational culture.

In the context of IFIs, a robust control environment fosters the surroundings that evaluate Shariah non-compliance risks, enabling the IFIs to fulfil its Shariah compliance objectives, implement control measures, utilise information and communication networks and carry out monitoring activities (Bouheraoua and Djafri, 2022). SGPD stressed on the needs for senior management and Board of Directors to take the lead in setting a precedent for defining Shariah compliance values and working behaviour that aligns with the Shariah compliance goals (Bank Negara Malaysia, 2019). If management demonstrates exemplary behaviour and conveys a strong commitment to ethical, integrity and Shariah compliance, this mind set will be conveyed to the staff, which directly establish a robust foundation for the IFIs.

Based on the COSO ICF, an effective IFIs must establish and implement a comprehensive set of guidelines that encompass relevant ethical, business, legal regulations and Shariah governance for all individuals involved in the IFIs, including executives, employees, as well as the external stakeholders (Moeller, 2016). The Board of Directors and its Board Committees should ascertain and comprehend the expectations of stakeholders towards assurance of Shariah compliance. These expectations should influence the Shariah compliance goals of IFIs and the supervisory duties of the Board. As highlighted by SGPD, management should develop clear structures, reporting lines and responsibilities, with proper Board monitoring in achieving its internal control objectives to comply with the Shariah principles (Bank Negara Malaysia, 2019). By having this organisational structure, IFIs will be able to establish an effective control environment which may consequently enhance the effectiveness of the internal Shariah audit function.

Risk Assessment

Contingency theory posits that risk assessment should consider the ever-changing nature of business environment (Drazin and Van de Ven, 1985). It is important for the organisation to regularly undertake risk assessments that consider potential changes in the external environment that could affect the organisation. In this respect, the process for establishing the management of risks at all levels is contingent upon the formulation of risk-related objectives, which are interconnected with the levels of organisational activities (Moeller, 2016). Management must clearly define and outline their risk objectives in the areas of operations, reporting and compliance. This clarity is necessary to effectively identify and analyse the risks associated with these objectives. Management should also assess the appropriateness of the objectives for the organisation. Moreover, risk assessment necessitates management to evaluate potential consequences of possible changes in the external environment and the company’s own business model that could undermine its internal controls (Moeller, 2016).

In the context of IFIs, risk assessment within the internal control system is contingent upon the establishment of the control functions in achieving the Shariah compliance objectives. IFIs should establish effective risk identification by recognising the potential Shariah non-compliance risks that could affect the IFI’s success (Yahya, Mahzan and Abu Hasan, 2018). The Shariah non-compliance risks should be listed in order of significance, starting from the most substantial risks that impact the entire business to the less significant risks associated with the business units. The objective is not to simply list all potential Shariah non-compliance risks, but rather to identify the ones that could potentially affect IFIs business operations.

The effective management of internal control risks has a significant impact on IFI’s capacity to achieve the ultimate Shariah compliance objectives. An IFI’s risk identification
process should be supported by range of activities, strategies and procedures, all of which are pertinent to the comprehensive risk assessment in order to achieve optimal effectiveness.

Control Activities

According to contingency theory, the design of control activities needs to be reliant on the particular requirements and attributes of the organisation (Pennings, 1975). This includes implementing control activities that are tailored to the specific risks and challenges encountered by the organisation. To establish effective control activities, organisations should implement segregation of duties as the key internal control procedures which is incorporated into the selection and development of COSO control activities (COSO, 2013). In cases where the implementation of segregation of duties is ineffective, management is required to choose and establish alternative control activities. Organisations should carefully choose and maintain control activities that effectively reduce internal control risks to acceptable risks, and subsequently achieve their objectives. In addition, organisations should establish control activities which encompass measures that guarantee the proper and timely execution of processes to evaluated risks, as well as other management instructions, such as the establishment of corporate code of ethics (Moeller, 2014). Although an organisation often has numerous policies and procedures to attain its goals, it is important to implement control activities that are directly linked to these policies and procedures. These control activities help to reduce risks and ensure that objectives are achieved at acceptable levels.

In order to maintain strong control activities, IFIs need to develop and implement effective rules and procedures to ensure that management’s instructions to reduce Shariah non-compliance risks to the attainment of goals are effectively executed (Bank Negara Malaysia, 2019). When identifying recommended steps to mitigate Shariah non-compliance risks, it is important for the IFIs to consider all parts of the internal control system, including the key business processes, IT systems and places where control activities are required (Abd Rahman, Mastuki, Osman and Kasim, 2020). This may involve evaluating control measures beyond the operating unit such as those undertaken by the external parties. It is also imperative for the competent individuals to thoroughly examine and take appropriate action on issues that arise during the implementation of control measures. This is important to ensure that the Shariah compliance objectives are incorporated into business processes and employees’ daily activities within the IFIs. By enforcing an effective control activity within the Shariah governance structure, robust management of Shariah non-compliance risks could be achieved.

Information and Communication

The contingency theory highlights the need of proficient communication that is customised to the particular circumstances (Otley, 1980). This includes taking into account the distinctive characteristics of the organisation, such as its magnitude, complexity and sector, while designing the communication methods. It is important for the organisation to establish an effective internal and external communication. Based on the COSO ICF, internal communication enhances the operation of internal control elements by exchanging information vertically, horizontally and throughout the organisation (COSO, 2013). Internal communications also facilitate the identification and analysis of issues or prospective issues by management and other staff, enabling them to implement appropriate corrective measures. On the other hand, external communications facilitate the acquisition and dissemination of information by management, pertaining to risk, regulatory affairs, and changes in
circumstances, customer satisfaction and other pertinent data that affects the operation of internal control components (Moeller, 2016).

Similarly, information is essential for IFIs to fulfil internal control obligations in order to accomplish its Shariah compliance objectives. The IFI’s objectives should be obtained from the Board of Directors and senior management and then streamlined in a manner that line management and other individuals may comprehend these objectives and their involvement in achieving them (Bank Negara Malaysia, 2019). Senior management should effectively convey the IFI’s Shariah compliance objectives to all levels of management and people, including external stakeholders, to ensure that everyone comprehends their specific tasks within the organisation (Abd Rahman et al., 2020). Such communication takes place irrespective of personnel’s geographical location, hierarchical position and functional role. Likewise, management’s communication with external stakeholders should effectively convey the significance of internal controls within the IFIs by demonstrating transparent channels of communication. Effective communication with external stakeholders of the IFIs is crucial in building a suitable control environment and facilitating their comprehension of IFIs’ values and Shariah compliance culture. Hence, it is important to provide the external stakeholders with information about IFIs’ code of conduct and Shariah compliant business operations to enhance their confidence.

Effective information and communication that is put in place within the IFIs’ organisational structure facilitate the acquisition and dissemination of information from both internal and external sources, enabling management to identify the conditions that could affect the attainment of internal control objectives (Bank Negara Malaysia, 2019). This is crucially important in establishing an effective control function that could lead to the achievement of Shariah compliance objectives.

**Monitoring Activities**

Contingency theory posits that the monitoring activities should possess adaptability and responsiveness to fluctuations in both the internal and external environment (Drazin and Van de Ven, 1985). This includes establish monitoring protocols that are capable of adjusting to changing risk factors and business circumstances. In this respect, organisations should regularly assess their monitoring activities and promptly identify any internal control weaknesses. It is important for the organisations to conduct ongoing evaluations which include regular assessments that are integrated into corporate processes and conducted in real-time, in response to changing circumstances (Moeller, 2016). When continuing assessments are integrated into company operations, their internal control elements are often designed to continuously monitor themselves. The assessments must be evaluated against the management’s criteria to determine the appropriate reporting line. Any internal control deficiencies that are identified should be communicated to the relevant members of organisation’s management who are capable of taking prompt corrective actions (Moeller, 2016).

In the context of IFIs, effective monitoring activities are crucial to ensure that IFIs have efficient control functions as well as effective internal Shariah audit that helps in performing several monitoring processes (Bank Negara Malaysia, 2019). Effective monitoring processes should result in IFI’s efficiency and cost reductions related to external reporting on internal control. This is because internal control issues within the IFIs can be discovered and resolved in a proactive manner. The continuous COSO monitoring processes resembles the continuous internal Shariah audit processes (COSO, 2013). This indicates that effective monitoring
activities that are in place within the IFI’s organisational structure could affect the effectiveness of internal Shariah audit function.

Based on the above arguments, this study proposed the modification of COSO ICF to incorporate the distinctive features of IFI’s business operations within each component of internal control system (COSO, 2013). This could facilitate IFIs to implement an effective control functions which could subsequently establish an effective Shariah compliance risk culture as required by BNM through SGPD (Bank Negara Malaysia, 2019). Table 3 summarised the 17 principles within the five (5) components of internal control system.

Table 3: Modification of COSO Internal Control Framework for IFIs

<table>
<thead>
<tr>
<th>Components</th>
<th>Principles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control Environment</td>
<td>1. Establish a robust leadership culture to foster ethical ideals and guarantee adherence to Shariah principles across all business operations.</td>
</tr>
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<td></td>
<td>2. Ensure that the Board of Directors remain independent from the management team to build a distinct vision and ethical standards that guarantees compliance with Shariah principles in IFIs.</td>
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<td>3. Create an ideal organisational framework and establish clear lines of communication for the Shariah control functions.</td>
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<td></td>
<td>4. Establish a strong succession plan to successfully attract and retain competent professionals who comply with the Shariah compliance goals in IFIs.</td>
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<td></td>
<td>5. Develop a system to improve communication and increase responsibility among the individuals in IFIs regarding the effectiveness of internal controls for Shariah compliance.</td>
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<tr>
<td>Risk Assessment</td>
<td>6. Define clear objectives that assist in the identification and evaluation of Shariah non-compliance risks.</td>
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<td></td>
<td>7. Establish and execute a thorough management strategy to effectively oversee and mitigate Shariah non-compliance risks, thereby striving to accomplish its goals.</td>
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<td></td>
<td>8. Consider the possibility of fraudulent activities while assessing the Shariah non-compliance risks in order to accomplish IFI's goals.</td>
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<tr>
<td></td>
<td>9. Assess any modifications that could have a substantial impact on the effectiveness of internal controls in ensuring Shariah compliance.</td>
</tr>
<tr>
<td>Control Activities</td>
<td>10. Choose and implement strategies to reduce ad manage Shariah non-compliant events, in order to help achieving the Shariah compliance objectives.</td>
</tr>
<tr>
<td></td>
<td>11. Identify and implement technology-based efforts to support the achievement of Shariah compliance objectives.</td>
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<tr>
<td></td>
<td>12. Implement policies and procedures that comply with Shariah principles, establish explicit expectations and successfully execute these policies in IFIs business operations.</td>
</tr>
<tr>
<td>Information and</td>
<td>13. Utilise relevant information to enhance the effectiveness of internal controls in order to ensure adherence to Shariah principles.</td>
</tr>
<tr>
<td>communication</td>
<td>14. Share information about Shariah control functions with internal stakeholders within the IFIs.</td>
</tr>
</tbody>
</table>
15. Communicate issues related to the impact of Shariah control functions to external stakeholders.

<table>
<thead>
<tr>
<th>Monitoring Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>16. Continuously review the presence of each internal control element in guaranteeing compliance with Shariah principles.</td>
</tr>
<tr>
<td>17. Assess and promptly report any internal control weaknesses related to Shariah compliance to the appropriate stakeholders responsible for implementing corrective actions.</td>
</tr>
</tbody>
</table>

Source: Adapted and modified from COSO (2013)

CONCLUSION

This paper highlights the significance of the internal control system for effective implementation of an internal Shariah audit function in IFIs. Future research is required to test the hypotheses and identified the main components that affect the effectiveness of the internal Shariah audit function. This paper contributes valuable insights that will force IFIs to reconsider the purpose Shariah audit and streamline the successful execution of the newly established SGPD. This policy document emphasises the criticality of implementing strong control functions that could facilitates the achievement of objective assurance for Shariah compliance in IFI’s business operations.

The fundamental proposition of this conceptual framework asserts that a more effective internal control system corresponds to a more effective internal Shariah audit function. The implementation of an effective internal control system is critically vital in achieving robust management of risks associated with non-adherence to Shariah principles.

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