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INTEGRATING FINANCIAL STATEMENT AUDIT AND SHARIAH GOVERNANCE: OPPORTUNITIES, BARRIERS, AND INSTITUTIONAL READINESS

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***Abstract*:** Shariah compliance constitutes a fundamental requirement in Islamic financial institutions (IFIs), underpinning their legitimacy, governance, and operational integrity. This paper examines the integration of Shariah compliance within financial audit processes, with particular emphasis on the potential role of Key Audit Matters (KAMs) as a mechanism for reporting significant Shariah-related issues. Drawing on the regulatory framework in Malaysia, as well as standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions and the Islamic Financial Services Board (AAOIFI), the study highlights the importance of a robust Shariah governance structure supported by effective assurance functions, including Shariah review, Shariah audit, and Shariah risk management. The paper proposes a conceptual framework in which Shariah audit serves as a critical mechanism for identifying non-compliance issues, which are subsequently assessed for their financial impact by external auditors. Where such issues are deemed material and significant, they may be disclosed in financial statements and communicated through KAMs to enhance transparency and stakeholder confidence. Nevertheless, the integration of Shariah-related matters into KAM reporting presents several challenges, including auditor competency limitations, potential overlaps in governance roles, and differences in the interpretation of materiality from both financial and Shariah perspectives. The study concludes that a coordinated, rather than fully integrated, approach is more appropriate, whereby Shariah audit and financial audit functions remain distinct but closely aligned. This approach ensures the preservation of institutional integrity while enabling meaningful disclosure of significant Shariah issues. The findings contribute to the growing discourse on strengthening Shariah governance and audit practices, particularly in enhancing the quality and relevance of auditor reporting in IFIs.

Keywords: Financial Statement Audit; Shariah compliance; Key Audit Matters; Shariah Audit; Shariah based Institutions.

1. Introduction

Shariah constitutes the cornerstone of Islamic Financial Institutions (IFIs); therefore, ensuring comprehensive Shariah compliance across all institutional operations is imperative to sustain public confidence. Any failure to uphold Shariah compliance throughout the entire operational process may result in significant adverse consequences, including financial losses and large-scale withdrawal of funds. In light of this, the Islamic financial system necessitates the institutionalisation of a robust Shariah governance framework to ensure end-to-end Shariah compliance in all aspects of Islamic finance practices. The establishment of such a framework is thus fundamental to the stability and integrity of the Islamic financial system.

In Malaysia, Shariah compliance refers to the requirement that all aims, operations, business activities, and financial transactions of Islamic Financial Institutions (IFIs) must be conducted in accordance with Shariah principles. These principles are derived from primary sources such as the Qur'an and Sunnah, as well as secondary sources including ijma' (consensus) and qiyas (analogy). Legally, Shariah compliance is explicitly defined under the Islamic Financial Services Act 2013 (IFSA 2013). Section 28(1) of the Act stipulates that an Islamic financial institution shall, at all times, ensure that its aims and operations, business, affairs, and activities are in compliance with Shariah. This provision establishes Shariah compliance as a statutory obligation, rather than merely a voluntary or ethical consideration.

From a regulatory perspective, Bank Negara Malaysia (2019) further elaborates this concept through its Shariah Governance Policy Document. Shariah compliance is viewed as a comprehensive and continuous process, encompassing product development, documentation, execution of contracts, financial reporting, and overall business conduct. It requires effective oversight by key governance organs, namely the board of directors, management, and the Shariah committee.

In practice, Shariah compliance in Malaysia also entails the avoidance of prohibited elements such as riba (interest), gharar (excessive uncertainty), and maysir (gambling), while ensuring that all transactions are conducted with transparency, fairness, and accountability. Non-compliance with Shariah requirements may result in regulatory actions, financial penalties, and the obligation to purify any income derived from non-compliant activities.

In contrast, AAOIFI (2017) approaches Shariah compliance from a standards-based and governance-oriented perspective. While AAOIFI (2017) does not provide a single statutory definition, it conceptualises Shariah compliance through its Shariah standards and governance standards, which require institutions to ensure that all products, contracts, and operations conform to Shariah rules and principles as determined by qualified Shariah scholars. AAOIFI (2017) places strong emphasis on the role of the Shariah Supervisory Board in certifying and monitoring compliance, thereby highlighting institutional oversight and scholarly authority as key components.

Similarly, the Islamic Financial Standard Board (IFSB) (2009) defines Shariah compliance within the broader framework of Shariah governance. According to its guiding principles, Shariah compliance refers to the adherence of all institutional activities to Shariah rules and principles, supported by effective oversight mechanisms, including Shariah review, audit, and risk management functions. The IFSB (2009) perspective emphasises process integrity and assurance mechanisms, focusing on how compliance is continuously monitored and verified rather than merely defined.

A key similarity across these frameworks lies in the recognition that Shariah compliance must encompass all aspects of institutional operations, including product structuring, execution, and reporting. All three also stress the importance of independent oversight, whether

through regulatory enforcement (Malaysia), Shariah supervisory boards (AAOIFI) (2017), or governance mechanisms (IFSB). However, notable differences exist. The Malaysian approach is distinct in its legal enforceability and regulatory centralisation, where non-compliance may trigger statutory penalties. In contrast, AAOIFI (2017) standards are generally advisory unless adopted by national regulators, and they prioritise scholarly interpretation. The IFSB (2009), on the other hand, adopts a principles-based approach, focusing on best practices in governance rather than prescriptive legal requirements.

2. Literature Review

2.1 Definition of Shariah-Based Institutions in Malaysia

In the Malaysian context, Shariah-based institutions generally refer to organisations whose operations, governance, and activities are fully guided and regulated by Shariah principles derived from the Qur'an, Sunnah, Ijma', and Qiyas. These institutions are established with the objective of ensuring that all financial and non-financial transactions are free from prohibited elements such as haram (violation of Shariah sanctity), riba (interest), gharar (excessive uncertainty), and maysir (gambling), while promoting ethical, transparent, and socially responsible practices.

Within the Islamic finance sector, Shariah-based institutions are more specifically recognised as Islamic Financial Institutions (IFIs), which include Islamic banks, takaful operators, Islamic windows, and development financial institutions offering Shariah-compliant products and services. In Malaysia, these institutions operate under a comprehensive legal and regulatory framework primarily governed by the Islamic Financial Services Act 2013 (IFSA), which mandates full compliance with Shariah requirements in all aspects of operations, governance, and risk management.

Additionally, Shariah governance within these institutions is guided by the Shariah Governance Policy Document issued by Bank Negara Malaysia (2019), which outlines the roles, responsibilities, and accountability of key stakeholders, including the board of directors, management, and Shariah committee Malik (2020).

Beyond the financial sector, Shariah-based institutions in Malaysia also encompass other entities such as zakat institutions, waqf authorities, Islamic cooperatives, and halal certification bodies, all of which operate based on Shariah principles to achieve socio-economic justice and public welfare (maslahah).

2.2 Overview of Shariah-Based Institutions in Malaysia

Malaysia is widely recognised as a global leader in Islamic finance and has developed a well-established and comprehensive ecosystem of Shariah-based institutions. The country adopts a dual financial system, where Islamic and conventional financial systems operate in parallel, allowing Islamic institutions to thrive within a supportive regulatory and legal environment.

The Islamic finance industry in Malaysia has experienced significant growth over the past decades, driven by strong regulatory support, innovation in financial products, and increasing public awareness of Shariah-compliant alternatives. Institutions such as Bank Islam Malaysia Berhad and Maybank Islamic Berhad have played a pivotal role in expanding the market share of Islamic banking and offering a wide range of products, including financing, investment, and wealth management services.

Furthermore, Malaysia has established itself as a global hub for sukuk (Islamic bonds), consistently ranking among the top issuers worldwide. The presence of regulatory bodies such as the Securities Commission Malaysia has further strengthened the development of Islamic capital markets, particularly through guidelines on sukuk issuance and Shariah-compliant investment instruments.

Despite these achievements, Shariah-based institutions in Malaysia continue to face several challenges. These include ensuring consistent Shariah interpretation across institutions, enhancing the effectiveness of Shariah governance practices, addressing talent shortages in Shariah expertise, and adapting to emerging risks such as digital finance and fintech innovations.

2.3 Importance of Shariah Compliance in Shariah-Based Institutions

Shariah compliance represents the foundational principle underpinning the establishment and operation of Shariah-based institutions. It ensures that all activities, transactions, and governance processes adhere strictly to Islamic legal and ethical principles derived from the Qur'an and Sunnah. The importance of Shariah compliance extends beyond mere regulatory obligation; it is central to the legitimacy, credibility, and sustainability of such institutions.

Shariah compliance is essential in preserving the religious legitimacy of Shariah-based institutions. These institutions are established with the explicit objective of providing alternatives to conventional systems that may involve prohibited elements such as riba (interest), gharar (uncertainty), and maysir (gambling). Any deviation from Shariah principles would undermine and compromise their identity as Shariah based institutions.

Adherence to Shariah principles is critical for maintaining public confidence and trust. Stakeholders, particularly Muslim customers, rely on the assurance that financial products and services are fully compliant with Islamic law. A failure in Shariah compliance may lead to reputational damage, loss of credibility, and withdrawal of funds, thereby affecting institutional stability. This highlights the need for effective oversight mechanisms as emphasised in frameworks issued by Bank Negara Malaysia (2019) and international standards such as those by Islamic Financial Services Board.

In addition, Shariah compliance plays a vital role in risk management. Non-compliance risk, often referred to as Shariah non-compliance risk, can result in financial penalties, income purification (i.e., disposal of non-compliant income), and legal implications. Therefore, robust internal controls, including Shariah audit, Shariah review, and Shariah risk management functions, are necessary to mitigate such risks and ensure continuous compliance Isa et. al. (2020).

Moreover, Shariah compliance contributes to the promotion of ethical and socially responsible practices. Islamic principles emphasise fairness, transparency, accountability, and the avoidance of exploitation. As such, Shariah-based institutions are expected to uphold high ethical standards, contributing to socio-economic justice and equitable wealth distribution within society.

Compliance with Shariah enhances regulatory alignment and governance effectiveness. In jurisdictions such as Malaysia, Shariah compliance is legally mandated under frameworks like the Islamic Financial Services Act 2013, which requires institutions to ensure that their aims, operations, and affairs are in accordance with Shariah. This legal backing reinforces the need for a structured Shariah governance system involving the board of directors, management, and Shariah committee.

Finally, Shariah compliance supports the long-term sustainability and competitiveness of Shariah-based institutions. In an increasingly competitive financial environment, institutions that consistently demonstrate strong compliance are more likely to attract investors, customers, and international stakeholders. It also strengthens Malaysia's position as a global hub for Islamic finance by ensuring consistency, reliability, and innovation within a Shariah-compliant framework.

3. Methodology

This study adopts a qualitative research design to achieve a deep, contextual understanding of how the integration of financial statement audits can strengthen Shariah compliance within Shariah based institutions. Qualitative inquiry is particularly suited for this study as it allows for the exploration of complex operational processes, professional judgments, and governance nuances that cannot be easily captured through quantitative metrics (Malik, 2020). By examining the lived experiences and insights of key actors within the audit ecosystem, this approach helps uncover structural, behavioral, and regulatory realities shaping contemporary Shariah audit practices in Malaysia (Isa et al., 2020).

3.1 Target Participants and Purposive Sampling

To ensure the generation of rich, specialized data, this study utilizes purposive sampling to select participants who possess direct operational exposure to Shariah auditing frameworks. The target interviewees are categorized into two core professional groups:

1. Internal Shariah Auditors: Professionals operating within Malaysian IFIs who are legally mandated under Bank Negara Malaysia's (BNM) Shariah Governance Policy Document (SGPD 2019) to provide independent internal assurance on Shariah compliance.
2. External Auditors: Chartered accountants from established public accounting firms who are responsible for statutory financial statement audits and are increasingly required to interface with Shariah assurance parameters when auditing public trust entities (Shafii & Zakaria, 2025).

A total of 5 key informants were interviewed, continuing until data saturation is reached—the point at which no new themes or conceptual insights emerge from subsequent discussions

3.2 Data Collection Instrument: Semi-Structured Interviews

Data collection was executed through semi-structured interviews. This instrument relies on a predetermined interview guide while remaining flexible enough to allow participants to expand on unexpected or highly technical topics.
The scope of the interview guide is specifically focused on exploring the strengthening of Shariah compliance through the integration of financial statement audits. The thematic discussion paths are organized into the following areas:

- The current intersection and data-sharing mechanisms between statutory financial audits and internal Shariah audit functions (Yasoa' et al., 2022).
- Operational barriers to integrating the two audit types, such as competencies, audit software alignment, and differences in risk-materiality definitions.

- The potential of utilizing International Standard on Auditing (ISA) 701 (Key Audit Matters) and Shariah assurance tools to enhance disclosures and public transparency (IAASB, 2015; Shafii & Zakaria, 2025).

3.3 Strengths of The Interview Method in This Study

Utilizing semi-structured interviews provides several distinct methodological advantages for this line of inquiry:

- Nuanced Exploration of Complex Frameworks: Shariah auditing operates within a dual regulatory environment—governed simultaneously by secular laws like the Islamic Financial Services Act (IFSA) 2013 and divine principles (Naqli and Aqli sciences). Interviews allow the researcher to probe deeply into how practitioners reconcile these two fields in everyday audit workflows.
- Flexibility and Adaptive Probing: Unlike rigid questionnaires, semi-structured interviews empower the researcher to ask follow-up questions when participants reference sensitive operational challenges, internal bank politics, or complex accounting overrides that affect compliance.
- Capturing Practitioner Subjectivity and Expert Knowledge: The integration of financial and Shariah audits is an evolving frontier in assurance reporting (Shafii & Zakaria, 2025). Interviews capture the critical professional judgments, tacit knowledge, and real-world frustrations of auditors that are omitted from standard corporate annual reports.

3.4 Data Analysis Procedures

All interviews will be audio-recorded with the explicit consent of the participants and transcribed verbatim. To protect the anonymity of the practitioners and their respective financial institutions, alphanumeric codes (e.g., Respondent IA-1, Respondent EA-1) will be assigned.

The transcripts will be analyzed using Thematic Analysis following a systematic coding approach. The data will be indexed into open, axial, and selective codes to isolate recurrent themes regarding audit integration barriers, shared risk parameters, and strategic solutions for elevating Shariah compliance integrity.

4. Discussion and Findings

4.1 Strengthening Shariah Compliance through Integration of Financial Statement Audit

Based on the methodology and scope outlined above, focusing on qualitative insights from internal Shariah auditors and external statutory auditors regarding the integration of financial audits to strengthen Shariah compliance—several general findings typically emerge in research of this nature within the Malaysian Islamic finance sector. Shariah compliance within Shariah-based institutions can be significantly strengthened through the integration of financial statement audit processes. While financial audits have traditionally focused on ensuring the truth and fairness of financial reporting, their scope in Shariah Based Institutions can be extended to incorporate Shariah compliance considerations. This integration reflects a more holistic assurance approach, aligning financial accountability with Shariah requirements.

Firstly, the integration enhances the effectiveness of internal control and governance frameworks. Financial statement audits evaluate internal controls over financial reporting, including transaction recording, classification, and disclosure. By embedding Shariah compliance checks within these audit procedures, institutions can ensure that financial transactions are not only accurately reported but also compliant with Shariah principles. This is consistent with regulatory expectations set by Bank Negara Malaysia (2019), which emphasises end-to-end Shariah compliance through a robust governance framework.

Secondly, integrating Shariah compliance into financial audits promotes comprehensive assurance and reduces duplication of functions. Traditionally, Shariah audits and financial audits are conducted as separate exercises, potentially leading to overlaps or gaps in coverage. A coordinated or integrated audit approach allows auditors to assess both financial accuracy and Shariah compliance simultaneously, particularly in areas such as revenue recognition, contract execution, and profit distribution. This approach is also aligned with the standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions, which encourage the harmonisation of financial and Shariah auditing practices.

Thirdly, such integration strengthens the management of Shariah non-compliance risk. Financial statement audits involve substantive and analytical procedures that can detect anomalies, irregularities, or misstatements. When these procedures incorporate Shariah parameters—such as the prohibition of riba, gharar, and maysir—they can also serve as an early detection mechanism for potential Shariah breaches. This reduces the likelihood of financial loss arising from the need to purify non-compliant income or from regulatory penalties.

Moreover, integration enhances transparency and stakeholder confidence. Financial statements are a primary source of information for stakeholders, including investors, regulators, and customers. When Shariah compliance is embedded within the audit of these statements, it signals a higher level of accountability and assurance. Stakeholders are more likely to trust institutions that demonstrate that their financial performance is not only accurate but also ethically and religiously compliant.

However, despite its advantages, the integration of Shariah compliance into financial statement audits presents several practical challenges. One key issue is the difference in audit objectives and expertise. Financial auditors are primarily trained in accounting and auditing standards, whereas Shariah compliance requires specialised knowledge in Islamic jurisprudence (fiqh al-muamalat). This creates a skills gap that may limit the effectiveness of integration unless auditors are adequately trained or multidisciplinary audit teams are established.

Additionally, there may be regulatory and structural constraints. In many jurisdictions, including Malaysia, Shariah audit is recognised as a distinct function within the Shariah governance framework. The Shariah Governance Policy Document issued by Bank Negara Malaysia (2019) clearly differentiates between Shariah review, Shariah audit, and external financial audit. Full integration may therefore blur lines of responsibility and potentially affect the independence of each function if not properly structured.

Another challenge relates to the scope and standardisation of procedures. Unlike financial audits, which are governed by well-established international standards, Shariah audit practices are still evolving and may vary across institutions. The absence of uniform guidelines on how to integrate Shariah compliance into financial audits can lead to inconsistencies in practice.

In conclusion, while Shariah compliance can indeed be enhanced through the integration of financial statement audits, such integration should be approached in a structured and controlled manner. A complementary model—where financial and Shariah audits remain

distinct but closely coordinated—may be more practical. This allows institutions to leverage the strengths of both functions while maintaining clarity of roles, independence, and compliance with regulatory expectations. Ultimately, effective integration contributes to stronger governance, improved risk management, and greater stakeholder confidence in Shariah-based institutions.

4.2 Integration of Shariah Compliance Disclosure via Key Audit Matters

Key Audit Matters (KAMs) are critical areas of an audit that require significant attention and judgment from the auditor. They are defined in the context of the International Standards on Auditing (ISA 701) (2015) and serve to inform stakeholders about the most significant issues encountered during the audit process.

The concept of Key Audit Matters (KAM) plays a pivotal role in enhancing the effectiveness of Shariah audits by emphasizing areas that demand significant auditor attention. This includes high-risk domains, the complex valuation of financial instruments, and unique aspects of revenue recognition specific to Islamic financial products. In the context of Shariah compliance, KAM is particularly focused on critical risks where non-compliance could lead to severe repercussions, such as income purification or the invalidation of contracts. This focus on Shariah compliance risk underscores the importance of meticulous auditing practices in Islamic finance. Furthermore, KAM serves to foster greater transparency within the audit process, effectively bridging the "information gap" on Shariah compliance that often exists between auditors and stakeholders. By promoting a clearer understanding of the audit's scope and findings, KAM enhances stakeholder confidence in the Shariah compliance of financial institutions. Additionally, KAM encourages two-way communication between auditors and the Shariah Committee or Board, thereby improving Shariah governance. This robust interaction ensures that significant issues are not only identified but also addressed in a timely manner, ultimately contributing to the integrity and reliability of Islamic financial practices.

The differing conceptualizations of Shariah compliance across Malaysia, AAOIFI and IFSB (2009) provide an important foundation for understanding the role of Shariah audit and the potential integration of Shariah issues into Key Audit Matters (KAMs). These frameworks collectively emphasize that Shariah compliance is not merely a theoretical requirement but must be operationalized through robust assurance mechanisms. The proposition that the reporting of Shariah-related issues can be integrated into financial statement audits through KAMs presents a compelling development in enhancing transparency and accountability within Shariah-based institutions. However, while this approach offers clear benefits, it also raises conceptual, regulatory, and practical concerns that warrant critical evaluation.

4.3 Conceptual Basis of Using KAMs for Shariah Issues

Key Audit Matters, as introduced under international auditing standards, particularly ISA 701 (2015), are intended to highlight matters that, in the auditor’s professional judgment, were of most significance in the audit of financial statements. In the context of Islamic Financial Institutions (IFIs), Shariah non-compliance issues—especially those with financial implications such as income purification, contract invalidity, or misclassification of transactions—could reasonably fall within this category.

Integrating Shariah-related matters into KAMs aligns with the broader objective of enhancing audit transparency. Given that Shariah compliance is central to the operations of

IFIs, its inclusion in auditor reporting signals that such matters are not peripheral but integral to the institution's financial and ethical performance.

In the Malaysian context, the legal enforceability of Shariah compliance under the Islamic Financial Services Act 2013 necessitates the establishment of formal Shariah audit functions. Shariah audit serves as an independent assurance mechanism to evaluate whether an institution's operations, transactions, and financial reporting are in line with Shariah principles. This aligns with the expectations of Bank Negara Malaysia (2019), which requires continuous monitoring and assessment of compliance through structured governance processes. Consequently, Shariah audit becomes a critical bridge between regulatory requirements and actual institutional practices Mohamad Puad (2022).

From the AAOIFI (2017) perspective, the emphasis on Shariah supervisory boards and compliance with detailed Shariah standards reinforces the need for ex-post verification, which is the core function of Shariah audit. This highlights that compliance must not only be ensured at the product development stage but must also be independently verified and documented. Similarly, the IFSB's (2009) focus on process integrity and assurance mechanisms further strengthens the argument that Shariah audit is indispensable in validating compliance across all operational stages.

The relevance of these frameworks becomes particularly evident when considering the integration of Shariah issues into KAMs. Since KAMs are intended to communicate matters of most significance in the audit of financial statements, Shariah non-compliance issues—especially those with financial implications—can logically fall within their scope. For example, invalid sequencing of aqad in a tawaruq contract, profit being wrongly recognised, and Shariah non-compliance asset. The deficiency was overlooked and only identified during the financial audit.

The Malaysian framework, with its strong legal and governance orientation, provides a compelling basis for such integration. Because Shariah compliance is a statutory requirement, any significant breach may be considered material not only from a financial perspective but also from a regulatory standpoint. This strengthens the justification for including such matters in KAM disclosures, thereby enhancing transparency and stakeholder confidence.

However, the integration of Shariah audit findings into KAMs must be approached with caution. The AAOIFI (2017) and IFSB (2009) frameworks clearly distinguish between different layers of assurance Sha, particularly the roles of Shariah committees and auditors. Direct incorporation of Shariah matters into KAMs may risk blurring these boundaries, especially if external auditors lack the necessary Shariah expertise. This raises concerns regarding competency, scope of responsibility, and the potential misinterpretation of Shariah issues by stakeholders.

4.4 Potential Benefits

1. Enhanced Transparency and Stakeholder Awareness

   Disclosing Shariah issues through KAMs would provide stakeholders with greater visibility into areas of concern that may affect both financial performance and Shariah integrity. This is particularly important in jurisdictions like Malaysia, where stakeholders place significant reliance on Shariah assurance frameworks guided by Bank Negara Malaysia (2019).

2. Strengthening Accountability and Governance

The inclusion of Shariah issues in KAMs could reinforce the accountability of management and the board in addressing Shariah non-compliance risks. It may also indirectly enhance the effectiveness of the Shariah governance framework by encouraging closer coordination between financial auditors and Shariah functions.

3. Bridging the Gap Between Financial and Shariah Audit

KAM disclosures can serve as a practical interface between conventional financial audits and Shariah audits. This supports a more integrated assurance model without fully merging the two functions, which remains consistent with the standards of Accounting and Auditing Organization for Islamic Financial Institutions that recognise the distinct yet complementary roles of different assurance mechanisms.

4. Exercise independence in Shariah compliance

The assessment of Shariah non-compliance is a critical function that requires a high degree of objectivity. Instances of timing errors, for example, may invalidate contracts and necessitate full profit purification. In Malaysia the Shariah audit function is done by the Internal auditors. However, internal auditors may exhibit a tendency to downplay the severity of such issues. This inclination can stem from various motivations, including:

- A desire to mitigate reputational damage
- An effort to limit financial repercussions
- An inclination to treat the issue as a minor timing discrepancy

Such biases can lead to significant oversights in the evaluation process, potentially allowing non-compliant transactions to persist unaddressed. In contrast, an independent auditor provides an essential counterbalance to these internal pressures. An independent auditor offers several advantages, including an unbiased assessment of the transaction, the application of substance over form in evaluations, and a clear determination regarding the validity of the transaction and the compliance of income generated. By ensuring that assessments are conducted without internal bias, independent auditors play a crucial role in safeguarding the integrity of Shariah compliance within IFIs.

A short acknowledgement section can be written between the conclusion and the references. Sponsorship and financial support acknowledgments should be included here. Acknowledging the contributions of other colleagues who are not included in the authorship of this paper is also added in this section. If no acknowledgement is necessary, this section should not appear in the paper.

4.5 Critical Challenges and Limitations

1. Scope and Competency Constraints

A fundamental issue lies in whether external financial auditors possess sufficient Shariah expertise to identify, assess, and report Shariah-related matters appropriately. Shariah compliance involves jurisprudential interpretation (fiqh al-muamalat), which may fall outside the professional competence of conventional auditors. Without proper collaboration with Shariah experts, KAM disclosures may be superficial or even misleading.

2. Risk of Overstepping Roles and Responsibilities

The integration of Shariah audit findings into KAMs must be approached with caution. The IFSA 2013, AAOIFI (2017) and IFSB (2009) frameworks clearly distinguish between different layers of assurance, particularly the roles of Shariah committees and

auditors. Direct incorporation of Shariah matters into KAMs may risk blurring these boundaries, especially if external auditors lack the necessary Shariah expertise. This raises concerns regarding competency, scope of responsibility, and the potential misinterpretation of Shariah issues by stakeholders.

The Shariah Governance Policy Document by Bank Negara Malaysia (2019) clearly delineates the responsibilities of the Shariah committee and Shariah audit function. Including Shariah issues in KAMs may blur these boundaries, potentially leading to overlaps or conflicts in accountability. There is a risk that external auditors could be perceived as assuming the role of Shariah auditors or Shariah committee members, which may undermine the governance structure.

3. Materiality and Relevance Concerns

KAMs are intended to focus on matters that are material to the financial statements. However, not all Shariah non-compliance issues have direct or material financial impacts. Some may be qualitative in nature but still significant from a religious or ethical perspective. Determining whether such issues qualify as KAMs presents a challenge, as the traditional concept of materiality in auditing may not fully capture Shariah considerations. Only those that are financially material and audit-significant should be considered. This reinforces the need for a filtering mechanism, where Shariah audit findings are evaluated in terms of their financial impact before being communicated in the auditor's report.

4. Potential Reputational Risks

While transparency is generally beneficial, disclosing Shariah issues in KAMs may expose IFIs to reputational damage, especially if the issues are not properly contextualised. Stakeholders may misinterpret the disclosures, leading to loss of confidence or unwarranted withdrawal of funds. This is particularly sensitive given that trust is a critical element in Islamic finance.

5. Lack of Standardisation and Guidance

Currently, there is limited specific guidance on how Shariah-related matters should be incorporated into KAM disclosures. The absence of standardised reporting practices may result in inconsistencies across institutions, reducing comparability and potentially confusing stakeholders.

5. Conclusion

Way Forward: A Balanced Approach. A pragmatic approach would be to adopt a coordinated reporting model rather than full integration. Under this approach, external auditors may include Shariah-related matters in KAMs only when they have a direct and material impact on financial statements. Such disclosures should be made in consultation with the Shariah committee and internal Shariah functions to ensure accuracy and appropriateness. Clear guidelines should be developed by regulators and standard-setting bodies, such as the Islamic Financial Services Board, to standardise practices and clarify roles.

While the inclusion of Shariah issues in Key Audit Matters offers a promising avenue for enhancing transparency and integrating financial and Shariah assurance, it is not without challenges. Issues related to auditor competency, role boundaries, materiality, and reputational risk must be carefully managed. Therefore, rather than full integration, a structured and collaborative approach is more appropriate to ensure that the benefits of KAM reporting are realised without undermining the integrity of the Shariah governance framework.

The Shariah Compliance Framework operates as a structured, step-by-step process that moves from foundational requirements to final financial disclosures. The proposed framework consists of the following sequential stages:

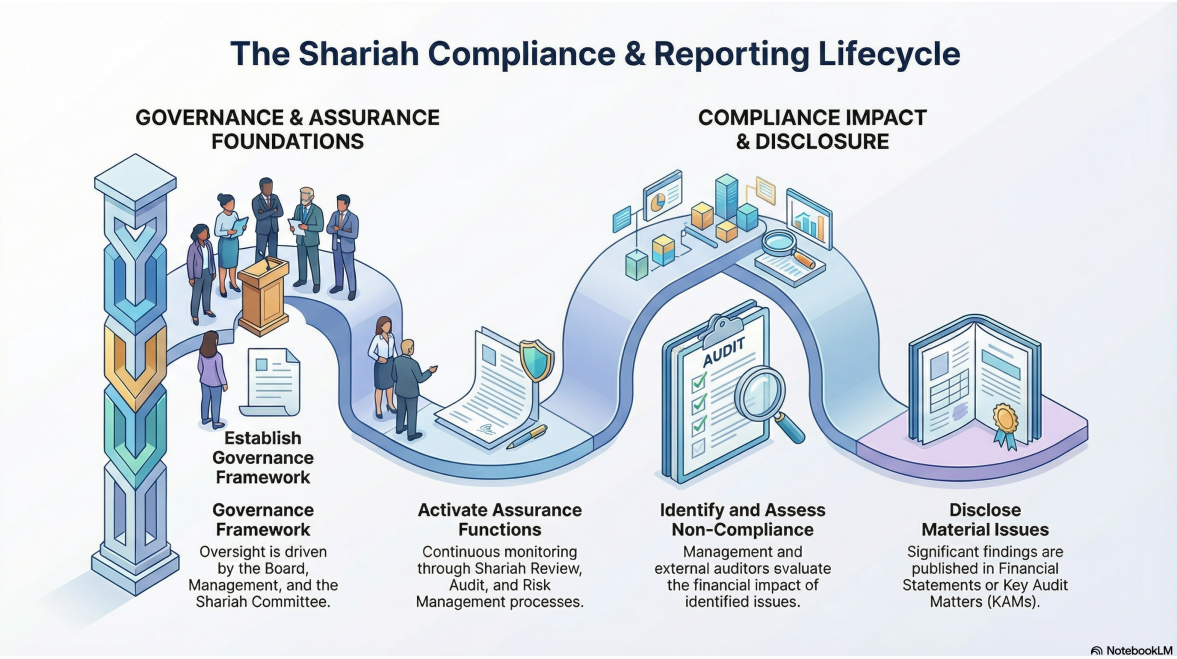


Figure 1: The Shariah Compliance and Reporting Lifecycle

The proposed framework is anchored in the fundamental requirement for full adherence to Shariah principles, which underpins all activities within Shariah based institutions. This requirement is operationalised through a structured Shariah governance framework comprising the board of directors, management, and the Shariah committee, each of whom bears distinct yet interrelated responsibilities in ensuring compliance. To support this governance structure, a set of Shariah assurance functions—namely Shariah review, Shariah audit, and Shariah risk management—are instituted to systematically monitor, assess, and enforce adherence to Shariah requirements Yasoa et. al. (2022).

The primary objective of these assurance functions is to identify and detect instances of Shariah non-compliance within the institution's operations and transactions. Upon identification, such issues are subjected to further evaluation, whereby management, in collaboration with the external auditor, assesses the financial implications arising from the non-compliance. This assessment is critical in determining the extent to which the identified issues affect the institution's financial position and performance. Where the impact is deemed material and significant, the issues are subsequently disclosed in the financial statements and communicated through KAMs, thereby enhancing transparency and providing relevant information to stakeholders.

In conclusion, the integration of Shariah compliance within the broader audit and reporting framework of Islamic financial institutions represents a critical step towards enhancing transparency, accountability, and stakeholder confidence Shafii & Zakaria (2025). The discussion demonstrates that while Shariah compliance is fundamentally a governance and religious obligation, its effective implementation relies heavily on robust assurance

mechanisms, particularly Shariah audit and financial audit processes. The potential use of KAMs as a reporting channel for significant Shariah issues further strengthens the link between Shariah governance and financial reporting by ensuring that material non-compliance is appropriately communicated to stakeholders.

However, such integration must be carefully structured to preserve the distinct roles, competencies, and independence of the various governance and assurance functions. A coordinated approach, rather than full convergence, is therefore more appropriate to ensure that Shariah audit findings are accurately assessed and only disclosed as KAMs when they meet the threshold of financial materiality and audit significance. Ultimately, this balanced approach reinforces the integrity of both Shariah governance and audit practices, contributing to the long-term stability and credibility of Islamic financial institutions.

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