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OPERATIONAL SHARIAH AUDIT IN ISLAMIC BANKS: CONCEPTUAL CLARITY AND PRACTICE GAP

Sri Sulistyowati[1]
Dalila Daud[2*]
Eley Suzana Kasim[2]
Azizi Abu Bakar[3]

[1] Faculty of Islamic Business and Economics, Universitas Islam Sultan Agung (Unisula) Semarang, PhD Student of Accounting Research Institute (ARI), UiTM Malaysia
[2] Faculty of Accountancy, Universiti Teknologi MARA, Cawangan Negeri Sembilan, Negeri Sembilan, Malaysia and Accounting Research Institute, Universiti Teknologi MARA, Shah Alam, Malaysia
[3]Islamic Business School, College of Business, Universiti Utara Malaysia, Sintok, Kedah, Malaysia
* Corresponding author: daliladaud@uitm.edu.my

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Abstract*:* *Operational Shariah Audit (OSA) is conceptualised as a distinctive audit domain within Islamic banks that integrates operational performance assurance with Shariah compliance. This paper undertakes a critical literature review of institutional standards and academic studies to examine the evolution of operational auditing and its adaptation within Islamic finance. Drawing on guidance from international audit institutions and Shariah governance frameworks, the review identifies persistent gaps that constrain the effective institutionalisation of OSA. Three key challenges emerge. First, the absence of a consolidated methodology results in inconsistent OSA practices across Islamic banks. Second, auditor competency remains limited, as effective OSA requires dual literacy in both professional auditing standards and fiqh al-muʿāmalāt. Third, regulatory and standard-setting frameworks remain fragmented across jurisdictions, undermining comparability and coherence. Anchored in Islamic Agency Theory and the maqāṣid al-Sharīʿah, OSA is positioned as a governance mechanism that ensures dual accountability—operational performance and Shariah integrity. This paper contributes by clarifying OSA as a distinct audit concept, synthesising key methodological and institutional gaps, and providing a conceptual foundation for future empirical research and regulatory development. The findings underscore the strategic role of OSA in strengthening Shariah governance and enhancing the credibility of Islamic banks.*

Keywords*: Operational Shariah Audit; Islamic Banks; Shariah Governance; Islamic Agency Theory; Maqasid al-Shariah*

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Introduction

Ensuring both operational efficiency and Shariah compliance has become increasingly critical for Islamic banks as the industry expands and regulators sharpen governance expectations (Alam et al., 2022; BNM, 2019; Haridan et al., 2018; IFSB, 2020; Mergaliyev et al., 2021). Operational auditing has long been recognised as a cornerstone of governance and accountability. In the public sector, it evolved as a mechanism to ensure value-for-money in the use of public resources (GAO, 1954; INTOSAI, 2019). In the private sector, operational audits have been positioned as strategic tools to enhance efficiency, effectiveness, and competitiveness (IIA, 1999; Moeller, 2005). Yet within Islamic banks, operational auditing cannot be confined to performance metrics alone. These institutions are equally bound by the imperative of Shariah compliance, which differentiates them from their conventional counterparts (Alam et al., 2022; Hameed, 2008; Karim & Archer, 2013; Mishref & Sa'ad, 2024; Yusoff et al., 2024).

This dual responsibility creates the need for a distinctive form of auditing—what this paper refers to as *Operational Shariah Audit (OSA)*. While the term has not been widely employed in either literature or practice, its conceptual introduction is necessary to differentiate it from conventional operational audit. Traditional OA focuses primarily on the 3Es—economy, efficiency, and effectiveness—as measures of organizational performance (GAO, 2018, 2024; IIA, 2017b, 2024; INTOSAI, 1995, 2019). In contrast, OSA must extend beyond these dimensions to safeguard compliance with Shariah principles and to ensure alignment with the maqasid al-shariah, which emphasise justice, fairness, welfare, and the prevention of harm (Chapra, 1992; Dusuki & Bouheraoua, 2011; Mergaliyev et al., 2021; Taufik et al., 2023). Without a clear terminological distinction, the conceptual and practical boundaries of Shariah-related auditing risk remaining blurred and underdeveloped.

OSA therefore plays a *dual role*. On one hand, it serves as a managerial tool for enhancing performance and managing operational risks. On the other, it functions as a governance mechanism that reinforces Shariah accountability, ensuring that business practices uphold the ethical, social, and religious commitments of Islamic finance (Algabry et al., 2020; Ayedh et al., 2021; Haridan et al., 2018; Mishref & Sa'ad, 2024; Yaacob & Donglah, 2012). This dual assurance—on both performance and compliance—is distinctive to Islamic banks and places OSA at the intersection of modern governance imperatives and Islamic ethical obligations.
Theoretically, OSA is best framed through the lens of *Islamic Agency Theory*, which extends conventional agency concerns by embedding a religious dimension of accountability. While traditional agency theory highlights conflicts between principals and agents (Jensen & Meckling, 2019; Meckling & Jensen, 1976), Islamic Agency Theory situates Allah as the ultimate principal, thereby expanding accountability beyond shareholders and regulators (Khalid & Sarea, 2021). Within this framework, OSA is not only a mechanism for aligning management actions with stakeholder interests but also an instrument for ensuring compliance with divine mandates.

Despite growing attention to Shariah governance, three persistent weaknesses in literature and practice reveal a clear *research gap*. First, there is *no consolidated methodology* for OSA. While INTOSAI (2019), (GAO, 2018); GAO (2024), and (IIA, 2017a); IIA (2024) provide guidance on operational auditing, and AAOIFI (2017) and IFSB (2006); (IFSB, 2009, 2020) outline Shariah governance standards, none offer a comprehensive framework for conducting OSA internally. Second, *auditor competence remains a critical concern*. Effective OSA requires dual literacy—professional auditing expertise combined with knowledge of fiqh al-muamalat—yet

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studies confirm that limitations in Shariah auditor capacity undermine effectiveness (Algabry et al., 2020; Haridan et al., 2018; Shahid et al., 2022). Third, *standards and regulatory frameworks remain fragmented*. Malaysia's Bank Negara Malaysia framework (2019) differs from AAOIFI and IFSB prescriptions, creating inconsistencies across jurisdictions (Alam et al., 2022; Grassa, 2015; Yusoff et al., 2024).

This paper makes three contributions to the literature. First, it introduces OSA as a distinct terminology, clarifying the conceptual boundaries of operational auditing within Islamic banks. Second, it synthesises institutional and academic literature to highlight methodological, competency, and regulatory gaps. Third, it provides a conceptual foundation that integrates Islamic Agency Theory and the maqasid al-shariah, laying the groundwork for future empirical studies and regulatory development.

Method of Review

This paper employs a critical literature review approach to examine the conceptual evolution of operational auditing and its adaptation within Islamic banks as Operational Shariah Audit (OSA). A critical review is appropriate for this study, as it goes beyond summarising existing work to synthesising key themes, exposing conceptual ambiguities, and identifying gaps that warrant further investigation (Creswell, 2017; Creswell & Poth, 2019; Snyder, 2019).

The sources examined comprise both institutional standards and academic contributions. Institutional references include authoritative guidelines such as INTOSAI's ISSAI 300 (2019), the GAO's Yellow Book (2018, 2024), the Institute of Internal Auditors' IPPF (IIA, 2017a, 2024), AAOIFI's Governance Standards (2017), and IFSB's governance frameworks (IFSB, 2006, 2009, 2020). Academic literature was selectively reviewed to capture conceptual, contextual, and sectoral dimensions of operational and Shariah auditing, including foundational works (Chapra, 1992; Hameed, 2008; Karim & Archer, 2013) and more recent studies (Algabry et al., 2020; Haridan et al., 2018; Mishref & Sa'ad, 2024).

The review does not seek exhaustive coverage but prioritises relevance. Three criteria guided the literature selection: (1) contributions to the historical and conceptual development of operational auditing, (2) insights into operational auditing across public, private, and Islamic finance sectors, and (3) discussions of integration between operational audit principles and Shariah governance mechanisms. The combination of institutional standards and academic studies allows for both breadth and depth, ensuring that the review captures both normative frameworks and critical academic debates.

By focusing on definitional clarity, institutional practices, and theoretical underpinnings, this review establishes the groundwork for positioning OSA as a distinctive domain of audit practice. It further provides a conceptual foundation for analysing the practice gaps that hinder OSA's institutionalisation, particularly in terms of methodology, auditor competence, and regulatory coherence.

Conceptual Foundations of Operational Auditing

Operational auditing (OA) has undergone significant evolution over the past century, shaped by demands for accountability, reforms in governance, and the pursuit of organizational efficiency. Its origins can be traced to early twentieth-century financial auditing, when the primary role of auditors was to verify the accuracy of records, detect fraud, and ensure compliance with applicable regulations (Power, 1997). At that stage, the scope of auditing was

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narrow, focused largely on safeguarding assets and preventing financial misstatements, with little concern for whether organizational resources were being managed effectively.

A major shift occurred after World War II, particularly in the United States, as public sector institutions began to recognize the limitations of audits that focused solely on financial accuracy. The U.S. General Accounting Office (GAO) pioneered performance-focused audits in federal agencies, developing an evaluative framework that emphasized the economy and efficiency of government programs (GAO, 1954). This marked the birth of operational or performance auditing as a distinct field, broadening the focus beyond financial compliance toward examining how resources were deployed and whether they achieved intended objectives.

By the 1960s to 1980s, international consensus began to coalesce around the 3Es framework: economy, efficiency, and effectiveness. Economy refers to minimizing the cost of resources without compromising quality, efficiency concerns the relationship between inputs and outputs, and effectiveness measures the extent to which objectives are achieved. These principles became institutionalized through the work of the International Organisation of Supreme Audit Institutions (INTOSAI), which issued guidance and standards that embedded the 3Es as the core evaluative criteria in performance auditing (INTOSAI, 1995, 2019). The 3Es provided a universal language for assessing organizational performance, adaptable to both public and private contexts.

During the 1980s and 1990s, operational auditing expanded rapidly into the private sector, where it was increasingly viewed as integral to internal audit functions. The Institute of Internal Auditors (IIA) promoted the idea of "value-added auditing," positioning internal auditors not merely as compliance monitors but as contributors to governance, risk management, and operational improvement (IIA, 1999). This redefinition shifted OA from a reactive, control-oriented activity toward a more proactive, advisory function aligned with management objectives. As a result, internal auditors began to engage with broader questions of strategic alignment, process optimization, and risk assessment.

Entering the twenty-first century, OA evolved into a strategic assurance and advisory function, encompassing not only efficiency and effectiveness but also issues of ethics, sustainability, and stakeholder value creation. Global reforms such as New Public Management (NPM) reinforced OA's role in public institutions, while private firms increasingly linked OA to corporate governance and enterprise risk management (INTOSAI, 2019; KPMG, 2021). At the same time, the growing complexity of organizational environments—particularly with the rise of digital technologies—pushed OA to incorporate advanced tools such as data analytics, continuous auditing, and artificial intelligence to enhance risk assessment and provide real-time insights.
This historical trajectory reveals both continuity and change. The continuity lies in the persistent centrality of the 3Es framework, which remains the cornerstone of OA definitions and practices across jurisdictions (GAO, 2018; INTOSAI, 2019). The change, however, lies in the expanding scope of OA, which now integrates governance evaluation, sustainability concerns, and digital transformation. Although terminology may differ—performance auditing in the public sector, value-added auditing in the private sector—the underlying principles remain consistent. For clarity, Table 1 summarizes selected milestones in the evolution of operational auditing, highlighting the institutions and definitions that shaped its development.

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Table 1: Selected Milestones in the Evolution of Operational Auditing

Year/ Period	Institution / Source	Definition Summary	Notes
1954	U.S. GAO (Yellow Book)	Introduced performance audits to assess economy and efficiency in public programs.	Marked the start of performance auditing in the U.S. federal sector.
1977 / 1995	INTOSAI Guidelines	Introduced the 3Es framework (economy, efficiency, effectiveness).	Established OA as a global standard.
1999	Institute of Internal Auditors (IIA)	Defined OA as systematic review of operations focused on efficiency, effectiveness, and compliance.	Promoted as part of value-added auditing.
2017 / 2024	IIA IPPF Standards	Emphasized auditors' role in governance, risk, and control.	Expanded internal audit scope to include operational review.
2018 / 2024	U.S. GAO Yellow Book	Defined performance auditing as objective analysis to improve programs and operations.	Updated federal standards.
2019	INTOSAI ISSAI 300	Defined OA as independent, objective examination based on the 3Es to identify improvements.	Current authoritative global definition.

Source: Compiled from GAO (1954, 2018, 2024); INTOSAI (1995, 2019); IIA (1999, 2017, 2024).

In summary, operational auditing has transformed from its early roots in financial verification into a multidimensional process that combines compliance, performance, governance, and strategic alignment. Its conceptual foundation rests on the 3Es, yet its practical application reflects broader organizational and societal expectations. This conceptual foundation provides the necessary backdrop for exploring how operational auditing is applied differently across sectors and, ultimately, how it is adapted within Islamic banks as OSA.

Operational Auditing across Sectors

While operational auditing (OA) rests on the common foundation of the 3Es framework, its application varies significantly across institutional contexts. Differences in governance structures, accountability mechanisms, and organizational objectives have shaped the scope, emphasis, and methodologies of OA in distinctive ways. A comparative analysis of public sector, private sector, and Islamic finance contexts reveals both the universality of OA principles and the contextual adaptations that make Operational Shariah Audit (OSA) a unique case.

Public Sector

In the public sector, OA—often referred to as *performance auditing*—is primarily aimed at safeguarding accountability and transparency in the use of public resources. Supreme Audit Institutions (SAIs), operating under the guidance of INTOSAI, play a central role in this domain. Their mandate extends beyond financial compliance to examine whether government programs are delivered economically, efficiently, and effectively (INTOSAI, 2019).

Public sector operational audits typically assess government programs, policy implementation, and service delivery outcomes. Effectiveness is especially emphasized, as audits frequently measure not only whether resources are used properly but also whether intended societal or policy objectives are achieved (Morin & Hazgui, 2016). For instance, audits may evaluate the success of a national health program in improving population well-being, or whether

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infrastructure projects achieve intended socio-economic impacts. Such audits thus transcend organizational boundaries and have far-reaching implications for citizens and governance legitimacy.

Private Sector

In contrast, OA in the private sector functions as a strategic management tool, closely aligned with business performance and competitiveness. Internal audit functions within corporations employ OA to provide management with insights into how organizational processes, units, or systems perform in relation to strategic goals (IIA, 2024; KPMG, 2021).

Areas of focus include supply chain efficiency, procurement processes, production systems, and risk-based audits that target operational and strategic risks. Private sector OA is often results-driven and oriented toward profitability, agility, and innovation. In practice, firms incorporate methodologies such as Six Sigma, Lean auditing, and advanced data analytics to identify inefficiencies and recommend improvements (Moeller, 2005). Unlike the public sector, where the ultimate measure is societal impact, the private sector emphasizes competitive advantage, shareholder value, and responsiveness to market dynamics.

Islamic Finance

OA within Islamic financial institutions embodies a *dual role*. Like in other sectors, it evaluates the efficiency and effectiveness of organizational performance. Yet, it must also ensure that operations comply fully with Shariah principles. This ethical-religious dimension fundamentally distinguishes OA in Islamic finance from its conventional counterparts (Karim & Archer, 2013; Mergaliyev et al., 2021).

In practice, operational auditing in Islamic banks requires verifying Shariah compliance in transactions, evaluating internal Shariah control systems, and assessing fairness, transparency, and risk-sharing mechanisms embedded in financial products (Rahman & Haron, 2019). This is typically coordinated with the *Shariah Supervisory Board (SSB)*, whose rulings and guidance must be effectively translated into daily operations (Puad et al., 2020). The ultimate objective extends beyond performance to include justice, welfare, and harm prevention in line with the maqasid al-shariah (Chapra, 1992; Taufik et al., 2023).

Such requirements impose unique demands on auditors, who must possess not only technical auditing skills but also knowledge of Islamic jurisprudence (fiqh al-muamalat). This dual literacy is essential to ensure that operational audits in Islamic banks deliver assurance on both financial efficiency and Shariah compliance (Shahid et al., 2022; Yaacob & Donglah, 2012).
Table 2 provides a comparative overview of how OA manifests across public, private, and Islamic finance sectors. While the principles of economy, efficiency, and effectiveness provide a shared foundation, the emphasis and outcomes differ considerably across contexts.

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Table 2: Comparative Features of Operational Auditing across Sectors

Sector	Main Objectives	Key Features of Operational Auditing	References
Public Sector	Accountability, transparency, value-for-money in public resource use	Performance audits by SAIs; evaluation of government programs and projects; policy and societal impact assessment; strong emphasis on effectiveness	INTOSAI (2019); Morin & Hazgui (2016); KPMG (2021); IIA (2024)
Private Sector	Business performance optimization, risk management, competitiveness	Process efficiency audits (supply chain, procurement, production); risk-based audits; benchmarking; use of Six Sigma, Lean, and data analytics	IIA (2024); KPMG (2021); Moeller (2005)
Islamic Finance	Dual objectives: operational efficiency and Shariah compliance	Verification of Shariah-compliant transactions; evaluation of internal Shariah controls; assessment of fairness, transparency, risk-sharing; coordination with SSB; pursuit of maqasid al-shariah; auditors require dual literacy	Karim & Archer (2013); Mergaliyev et al. (2021); Chapra (1992); Rahman & Haron (2019); Taufik et al. (2023)

Source: INTOSAI (2019); Morin & Hazgui (2016); KPMG (2021); IIA (2024); Moeller (2005); Karim & Archer (2013); Mergaliyev et al. (2021); Chapra (1992); Rahman & Haron (2019); Taufik et al. (2023).

In sum, operational auditing demonstrates **contextual diversity** despite sharing a common foundation. Public sector OA emphasizes accountability to citizens and policy outcomes, private sector OA stresses efficiency and competitiveness, and OA in Islamic finance integrates both performance and compliance with religious principles. This comparative analysis provides the foundation for examining OSA as a distinct adaptation of OA within Islamic banks.

Operational Shariah Audit (OSA) within Islamic Banks

Operational auditing within Islamic banks assumes a dual role that distinguishes it from conventional practice. While it shares with traditional operational auditing the objectives of ensuring economy, efficiency, and effectiveness, its scope is inseparable from safeguarding Shariah compliance. This dual responsibility elevates operational auditing in Islamic banks to a strategic governance mechanism—one that reinforces accountability, transparency, and ethical integrity while also strengthening institutional credibility in the eyes of regulators, stakeholders, and society.

Role and Relevance

The role of OSA extends well beyond conventional performance measurement. On the one hand, it seeks to ensure that the operational processes of Islamic banks are efficient, effective, and aligned with strategic objectives. On the other, it must confirm that these processes adhere to Shariah principles (AAOIFI, 2017; Hameed, 2008). In this sense, OSA provides *dual assurance*: that operational goals are being achieved and that those goals are pursued in ways consistent with Islamic ethical standards (Karim & Archer, 2013; Yaacob & Donglah, 2012).
In practice, this means that OSA ensures business activities not only generate profit but also align with the maqasid al-shariah, which emphasize justice, fairness, and welfare (Chapra, 1992; Mishref & Sa'ad, 2024). By identifying performance gaps, weaknesses in internal Shariah controls, and emerging risks, OSA contributes to continuous institutional improvement (Algabry et al., 2020). Thus, OSA functions not merely as a compliance mechanism but as a strategic tool that sustains credibility and trust in Islamic financial institutions.

Integration with Shariah Governance

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Islamic banks operate under distinct Shariah governance frameworks that include structures such as the Shariah Supervisory Board (SSB) and Shariah compliance departments. These bodies oversee adherence to Islamic principles, but their rulings and guidance require effective operationalization within the institution. While Shariah audits verify the conformity of contracts and products, OSA complements this process by assessing whether Shariah decisions are effectively embedded in day-to-day operations (Hameed, 2008).

OSA therefore plays a critical role in evaluating the functionality and robustness of internal Shariah controls, ensuring that decision-making processes, documentation, and reporting systems are aligned with both organizational objectives and Shariah requirements (Grassa, 2015; Karim & Archer, 2013). In this sense, OSA tests whether fatwas and rulings issued by the SSB are consistently implemented at the operational level (Alam et al., 2023; Puad et al., 2020). Where gaps exist in translating Shariah guidance into practice, OSA provides actionable recommendations to management.

The effectiveness of Shariah compliance, then, is directly linked to the extent to which OSA is integrated into the governance structure of Islamic banks. Without such integration, the risk of non-compliance grows, undermining institutional credibility and stakeholder trust (Alam et al., 2022; Haridan et al., 2018).

Unique Features of OSA

Several characteristics distinguish OSA from conventional operational auditing. **First,** Conventional banks emphasize performance, efficiency, and risk control. Islamic banks, however, must evaluate these dimensions within the boundaries of Shariah compliance. This means that OSA simultaneously assesses profitability and ethical soundness, ensuring that justice, fairness, and transparency are upheld in line with the maqasid al-shariah (Isa et al., 2020; Malaya, 2016; Mergaliyev et al., 2021).

Second, in addition to conventional governance bodies such as boards of directors and audit committees, Islamic banks are supervised by Shariah Supervisory Boards (SSBs). The presence of SSBs requires coordination between Shariah scholars, compliance officers, and internal auditors to ensure that rulings are consistently implemented in daily operations (Mishref & Sa'ad, 2024; Nomran et al., 2018; Puad & Shafii, 2019).

Third, while conventional OA applies the 3Es, OSA incorporates Shariah-based objectives. This expansion includes safeguarding against Shariah non-compliance risk, which carries both reputational and regulatory implications (Grassa, 2015; Yusoff et al., 2024).

Finally, ethical accountability in conventional audits is often implicit. In Islamic banks, it is explicitly embedded in governance frameworks. OSA requires auditors to possess dual literacy—proficiency in auditing standards and knowledge of Islamic jurisprudence (*fiqh al-muamalat*). Without this dual competence, auditors may struggle to identify operational weaknesses that could inadvertently lead to Shariah breaches (Shahid et al., 2022; Yaacob & Donglah, 2012). These distinctions can be summarised in Table 3, which contrasts conventional OA with OSA.

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Table 3: Unique Features of Conventional OA and OSA

Feature	Conventional OA	OSA in Islamic Banks	References
Audit Focus	Performance, efficiency, risk control	Performance within Shariah boundaries, justice, fairness, maqasid orientation	Almutairi & Quttainah (2020); Hameed (2008); Isa et al. (2020); Mergaliyev et al. (2021)
Governance Structure	Board of Directors, Audit Committee	Includes Shariah Supervisory Board; coordination with Shariah scholars and compliance officers	Mishref & Sa'ad (2024); Nomran et al. (2018); Puad & Shafii (2019)
Audit Criteria	3Es (Economy, Efficiency, Effectiveness)	3Es + Shariah objectives; emphasis on Shariah non-compliance risk	Grassa (2015); Yusoff et al. (2024)
Ethical Dimension	Implicit in governance frameworks	Explicit in Shariah governance; requires dual literacy (audit + fiqh muamalah)	Shahid et al. (2022); Yaacob & Donglah (2012)

Source: Almutairi & Quttainah (2020); Hameed (2008); Isa et al. (2020); Mergaliyev et al. (2021); Mishref & Sa'ad (2024); Nomran et al. (2018); Puad & Shafii (2019); Grassa (2015); Yusoff et al. (2024); Shahid et al. (2022); Yaacob & Donglah (2012).OSA as Part of Shariah Audit Practice

The literature also highlights the overlap and distinctions between OSA and Shariah auditing more broadly. Hameed (2008) defines Shariah auditing as a systematic process of obtaining and evaluating evidence to assess correspondence with Shariah. Similarly, AAOIFI's Governance Standards (GSIFI 2) describe Shariah audit as a review of compliance across all institutional activities. While Shariah audit ensures that contracts and products meet Islamic requirements, OSA extends this function by embedding Shariah compliance into operational processes and systems.

Recent studies note that internal Shariah audits often adopt methodologies similar to operational audits, such as risk-based internal auditing (RBIA) and COSO frameworks, while adding a specific focus on Shariah risk exposure and maqasid objectives (Puad et al., 2020; Shahid et al., 2022). This convergence underscores the value of OSA as a practical mechanism that bridges the gap between Shariah rulings and daily operations.

Strategic Importance of OSA

Finally, OSA should be viewed as a **strategic pillar** of Islamic corporate governance. Effective OSA enhances institutional credibility by demonstrating to regulators, shareholders, and customers that Islamic banks are not only operationally sound but also ethically compliant. It also mitigates reputational risk, which is particularly severe in Islamic finance given the sensitivity of non-compliance issues (Alam et al., 2022; Haridan et al., 2018). Moreover, by embedding Shariah accountability into operations, OSA strengthens public trust in Islamic finance as a whole, reinforcing its legitimacy as an ethical alternative to conventional finance.
In summary, OSA is not merely a variant of conventional operational auditing but a **distinctive adaptation** shaped by the requirements of Shariah governance. It provides dual assurance on performance and compliance, integrates with governance structures such as SSBs, incorporates Shariah objectives into audit criteria, and demands dual literacy from auditors. By clarifying these features, OSA can be positioned as a cornerstone of both effective governance and ethical accountability in Islamic banks.

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Standards and Regulatory Guidance

The practice of operational auditing is shaped by a range of international and institutional standards. While these frameworks provide valuable benchmarks, they vary significantly in scope and intent, and few address the unique requirements of internal Operational Shariah Audit (OSA) in Islamic banks. A review of both conventional and Islamic standards illustrates both the contributions and the limitations of existing guidance.

International Standards for Operational Audit

The most influential source of operational auditing standards in the public sector is the *U.S. Government Accountability Office (GAO)*. Its "Yellow Book" guidelines, first issued in 1954, established early principles for assessing economy and efficiency in government programs (GAO, 1954). Over time, these standards have evolved to define performance auditing as "an objective and systematic analysis of evidence to improve program performance and operations" (GAO, 2018, 2024). The Yellow Book continues to be a global reference point, particularly for SAIs and public auditors.

In the international domain, the *International Organisation of Supreme Audit Institutions (INTOSAI)* has played a pivotal role. INTOSAI's ISSAI 300 (2019) sets out the principles of performance auditing, emphasizing independence, objectivity, reliability, and the application of the 3Es (economy, efficiency, effectiveness). These standards, widely adopted by SAIs worldwide, have reinforced the role of operational auditing in promoting transparency and accountability in the public sector.

Private sector practice is most closely aligned with the *Institute of Internal Auditors (IIA)*, whose International Professional Practices Framework (IPPF) defines internal auditing as an "independent, objective assurance and consulting activity designed to add value and improve an organization's operations" (IIA, 2017a, 2024). While the IPPF does not provide a prescriptive methodology for operational auditing, it outlines relevant principles under sections such as governance (2100), engagement planning (2200), and monitoring progress (2500). These standards position internal auditors as evaluators of governance, risk management, and control processes, implicitly encompassing operational audit activities.

Other national standards provide additional guidance. For example, the *Australian Auditing and Assurance Standards Board (AUASB)* developed ASAE 3500 for performance engagements, which covers audit planning, criteria, and reporting (AUASB, 2022). While less prescriptive than financial audit standards, it reflects the global shift toward evaluating performance and outcomes rather than merely compliance.

Taken together, these international frameworks contribute significantly to defining operational auditing principles. However, their orientation is largely toward external or public sector audits, and their application to internal OSA within Islamic banks is indirect at best.

Islamic Standards for Shariah Governance and Audit

In Islamic finance, standards-setting bodies have sought to formalize governance structures and Shariah compliance mechanisms. The *Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)* has issued Governance Standards (GSIFI), including GSIFI No. 2 on Shariah review and GSIFI No. 3 on internal Shariah audit (AAOIFI, 2017). These documents emphasize the need for systematic processes to evaluate compliance with Shariah,

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covering contracts, policies, and operations. While highly relevant, they do not provide detailed methodologies for conducting operational audits within Islamic banks.

The *Islamic Financial Services Board (IFSB)* has also contributed key guidance. IFSB-3 (2006) outlined corporate governance principles for Islamic financial institutions, while IFSB-10 (2009) addressed risk management in a Shariah-compliant framework. More recently, IFSB-31 (2020) has refined governance standards, stressing the importance of Shariah oversight and effective internal control systems. These standards collectively reinforce Shariah governance requirements, but like AAOIFI, they remain broad in scope and do not offer a dedicated operational audit methodology.

National regulators have also developed context-specific frameworks. The most prominent example is *Bank Negara Malaysia's Shariah Governance Framework (SGF)*, first issued in 2010 and updated in 2019. The SGF mandates Shariah audit as a compulsory function within Islamic banks, requiring the establishment of audit manuals, qualified auditors, and integration of Shariah audit into annual audit planning (BNM, 2019). This framework is among the most advanced globally, setting a benchmark for integrating Shariah compliance into governance systems. Nonetheless, even in Malaysia, the focus is on Shariah audit broadly, without distinct elaboration of OSA as a separate domain.

Critical Gaps in Standards

Although these international and Islamic standards contribute significantly to the conceptualization of operational and Shariah auditing, several gaps remain evident.

First, the absence of consolidated methodologies. While GAO, INTOSAI, and IIA outline principles for operational auditing, and AAOIFI and IFSB prescribe Shariah governance requirements, no single standard provides a comprehensive methodology for internal OSA in Islamic banks. This leaves institutions to adapt frameworks ad hoc, creating inconsistency in practice.

Second, fragmentation of standards. Different jurisdictions apply varying regulatory frameworks, leading to divergence in practice. For instance, Malaysian banks comply with BNM's SGF, while banks in other regions may rely on AAOIFI or IFSB standards. This fragmentation undermines comparability and creates challenges for harmonization across the global Islamic finance industry (Alam et al., 2022; Grassa, 2015).

Third, limited attention to auditor competence. Existing standards emphasize governance structures and audit processes but pay relatively little attention to the dual literacy required of OSA auditors—proficiency in both audit methodologies and Islamic jurisprudence (fiqh al-muamalat). The lack of explicit competency standards exacerbates the difficulties faced by Islamic banks in building effective OSA capacity (Shahid et al., 2022; Yaacob & Donglah, 2012).

These gaps highlight the limitations of current regulatory guidance and underscore the need for conceptual clarification and methodological development. Table 4 summarises the major international and Islamic standards relevant to OA and OSA, along with their scope and limitations.

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Table 4: International and Islamic Standards Relevant to OA and OSA

Standard / Framework	Issuing Body	Focus Area	Relevance / Limitations for OSA
Yellow Book (2018, 2024)	GAO (USA)	Performance auditing (fieldwork, reporting, criteria)	Conceptual benchmark; limited relevance to internal OSA in Islamic banks
ISSAI 300 (2019)	INTOSAI	Performance audit principles	Widely applied; oriented to SAIs, not internal auditors
ASAE 3500 (2008)	AUASB (Australia)	Performance engagements	Planning and reporting guidance; not tailored to OSA
IPPF (2017, 2024)	IIA	Governance, engagement planning, monitoring	Relevant to internal audit; lacks prescriptive operational audit methodology
GSIFI 2 & 3 (2017)	AAOIFI	Shariah review and internal audit	Focused on Shariah compliance; does not integrate operational audit methodology
IFSB-3 (2006), IFSB-10 (2009), IFSB-31 (2020)	IFSB	Governance and risk management	Reinforce governance; limited on operational audit execution
SGF (2010, 2019)	Bank Negara Malaysia	Shariah governance and audit	Strongest national framework; still does not distinguish OSA as a unique domain

Source: Compiled from GAO (2011, 2018, 2024); INTOSAI (2019); AUASB (2008); IIA (2017, 2024); AAOIFI (2017); IFSB (2006, 2009, 2020); BNM (2019).

In sum, while global and Islamic standards provide essential benchmarks for operational and Shariah auditing, they fall short of addressing the unique challenges of OSA. The absence of consolidated methodologies, the fragmentation of regulatory frameworks, and the lack of competency standards for auditors highlight the need for conceptual clarity and methodological innovation. These challenges form the basis for the critical discussion that follows.

Discussion

The preceding review underscores that while operational auditing has matured into a well-defined practice globally, its adaptation within Islamic banks remains conceptually fragmented and practically underdeveloped. The introduction of the term *Operational Shariah Audit (OSA)* is therefore not merely semantic, but necessary to capture the unique dual role of operational auditing in Islamic finance: ensuring performance while safeguarding compliance with Shariah. This discussion synthesizes the literature to highlight three critical gaps—methodological, competency-related, and regulatory—and situates OSA within broader theoretical perspectives that illuminate its potential as a distinctive governance mechanism.

Methodological Gaps

The first and most evident gap is the absence of a consolidated methodology for OSA. While standards such as INTOSAI's ISSAI 300 (2019), GAO's Yellow Book (2018, 2024), and the IIA's IPPF (2017b, 2024) provide comprehensive guidance for operational audits, they do not address the integration of Shariah compliance into audit objectives. Similarly, Islamic standards such as AAOIFI's GSIFI 2 and 3 (2017) and IFSB governance frameworks (2006, 2009, 2020) emphasise Shariah assurance, but without prescribing methodologies for operational evaluations. This has left Islamic banks to adapt existing frameworks in an ad hoc manner, often leading to inconsistencies both within and across institutions (Alam et al., 2022; Grassa, 2015). The lack of methodology creates ambiguity in practice. Should OSA follow the same steps as conventional operational audits but with an added Shariah checklist? Or should it integrate

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Shariah objectives as evaluative criteria at every stage of audit planning, execution, and reporting? The literature does not provide a definitive answer, underscoring the urgency for methodological innovation. Without clear guidance, auditors risk conducting Shariah compliance checks in isolation, thereby missing the broader operational dimensions that link performance with ethical accountability.

Competency Gaps

A second major gap concerns the competencies of Shariah auditors. OSA requires *dual literacy*: proficiency in audit methodologies and technical standards, alongside knowledge of Islamic jurisprudence (fiqh al-muamalat). Yet, empirical studies consistently point to limitations in this area. Haridan et al. (2018) and Algabry et al. (2020) find that the effectiveness of internal Shariah audits is constrained by inadequate training, lack of independence, and insufficient institutional support. Shahid et al. (2022) further argue that the absence of standardized professional certification for Shariah auditors exacerbates these challenges.

The dual literacy requirement is more demanding than in conventional auditing. Whereas conventional auditors can rely primarily on technical and regulatory expertise, Shariah auditors must also interpret religious rulings, assess their operational implications, and ensure that complex financial products comply with ethical and legal norms of Islam. This competency gap poses significant risks, including the possibility of undetected Shariah non-compliance, reputational damage, and erosion of stakeholder trust.

Regulatory and Standardisation Gaps

A third gap arises from the *fragmentation of standards and regulatory guidance*. Different jurisdictions follow divergent frameworks: Malaysia's Bank Negara Malaysia (BNM) enforces a comprehensive Shariah Governance Framework (2019), while other jurisdictions rely on AAOIFI or IFSB guidelines. This results in significant variation in how OSA is interpreted and implemented. Alam et al. (2023) note that such fragmentation undermines comparability and weakens the ability of Islamic finance to present a unified standard of Shariah assurance globally.

Moreover, existing standards often stop short of prescribing operational-level procedures, leaving gaps between high-level governance requirements and daily audit practice. The lack of harmonization complicates cross-border supervision and may hinder the international credibility of Islamic banks, particularly as the industry aspires to greater integration within the global financial system.

Theoretical Perspectives: Islamic Agency Theory and Maqasid al-Shariah

These practice gaps can be illuminated through two complementary theoretical lenses: *Islamic Agency Theory* and *Maqasid al-Shariah*.

Conventional agency theory (Jensen & Meckling, 2019) frames the auditor as a mechanism to mitigate conflicts between principals (owners) and agents (managers). In Islamic banking, this relationship is expanded by *Islamic Agency Theory*, which introduces Allah as the ultimate principal (Khalid & Sarea, 2021). The accountability of agents thus extends beyond shareholders and regulators to encompass spiritual responsibility. Within this framework, OSA becomes a crucial mechanism for ensuring that management actions align not only with organizational objectives but also with divine mandates. By embedding Shariah principles into

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operational audit criteria, OSA addresses the dual agency problem of Islamic banks—between owners and managers, and between humans and God.

The lens of *Maqasid al-Shariah* adds another layer of insight. While the 3Es framework captures performance dimensions, maqasid principles demand that organizational activities promote justice, welfare, and harm prevention (Chapra, 1992; Dusuki & Bouheraoua, 2011). Integrating maqasid into OSA ensures that operational audits transcend narrow efficiency metrics to assess whether Islamic banks contribute to societal well-being and ethical outcomes. For example, an operational audit might evaluate whether profit-sharing contracts are implemented fairly between banks and customers, or whether financing practices avoid undue exploitation. In this sense, OSA operationalises maqasid by aligning day-to-day practices with the higher objectives of Shariah (Mergaliyev et al., 2021; Taufik et al., 2023).

Together, these theoretical perspectives highlight the *distinctive conceptual space* occupied by OSA. It is not merely operational auditing with an added compliance checklist, but a hybrid governance mechanism that unites performance assurance with ethical and spiritual accountability.

Implications for Theory and Practice

This synthesis has several important implications. Theoretically, it clarifies OSA as a distinct audit domain that bridges agency theory and maqasid frameworks. It contributes to audit scholarship by demonstrating how conventional governance concepts can be extended into religious-ethical domains. Practically, it underscores the need for regulators, Islamic banks, and professional bodies to address methodological, competency, and standardisation gaps.

For regulators, the priority lies in harmonising standards across jurisdictions to reduce fragmentation and enhance global credibility. For Islamic banks, the challenge is to institutionalise OSA by strengthening internal audit departments, ensuring independence, and integrating Shariah objectives into audit planning. For auditors, the agenda must include specialised training and certification that combines audit methodologies with fiqh al-muamalat. In short, OSA must evolve from a loosely defined practice into a structured and professionalised field. Only then can it deliver on its dual promise: assuring operational performance while safeguarding Shariah compliance.

Conclusion

This paper has sought to clarify the concept and practice of *Operational Shariah Audit (OSA)* within Islamic banks. Through a critical literature review, it traced the historical evolution of operational auditing, compared its application across sectors, and highlighted how OSA emerges as a distinctive adaptation that combines performance evaluation with Shariah compliance.

Three critical gaps stand out from the review. First, the *absence of a consolidated methodology* means that OSA lacks a standardised process for integrating Shariah objectives into audit criteria. Islamic banks often rely on ad hoc adaptations of conventional frameworks, leading to inconsistencies in practice. Second, the *competency gap* among Shariah auditors remains a pressing issue. Effective OSA requires dual literacy in both auditing standards and Islamic jurisprudence, yet training and certification remain limited. Third, the *fragmentation of regulatory standards* across jurisdictions has produced a patchwork of guidance, undermining global comparability and cohesion in the practice of Shariah auditing.

The paper's contribution lies in positioning OSA as a *distinctive audit domain*. By introducing the terminology explicitly, it distinguishes operational auditing in Islamic banks from its conventional counterpart. Conceptually, it demonstrates how OSA extends beyond the 3Es framework by embedding the maqasid al-shariah, thereby aligning operational practices with justice, welfare, and harm prevention. Theoretically, it integrates *Islamic Agency Theory*, framing OSA as a mechanism that addresses both the conventional principal–agent problem and the higher spiritual accountability to Allah as the ultimate principal.

The practical implications are equally significant. Regulators should prioritise harmonisation of standards and develop dedicated guidance for OSA. Islamic banks must institutionalise OSA within their governance systems, strengthening independence, integration with Shariah supervisory functions, and operational embedding of Shariah rulings. Professional bodies should establish certification programmes that combine audit and fiqh expertise, ensuring that auditors are equipped for the dual demands of OSA.

Looking ahead, future research should focus on three areas. First, developing and testing a *comprehensive OSA framework* that integrates conventional audit methodologies with Shariah principles. Second, conducting *empirical studies* to examine how OSA is practiced across different jurisdictions, and how variations in regulatory frameworks shape its effectiveness. Third, evaluating the *impact of OSA on stakeholder trust and institutional credibility*, thereby substantiating its strategic value for Islamic finance.

In conclusion, OSA should not be understood merely as an extension of operational auditing but as a strategic mechanism that ensures both performance and compliance in Islamic banks. By providing dual assurance—on efficiency and on Shariah integrity—OSA strengthens the legitimacy of Islamic finance and contributes to its sustainable development as an ethical financial system.

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