

Competency of Shariah Auditors in Islamic Banking Institutions: Challenges and Pragmatic Solution

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Abstract

Islamic banking is a Shariah-compliant alternative to the conventional banking system. All operations, products, and businesses adhere to Shariah guidelines in Islamic banking. The responsibility of Shariah auditors is to ensure that all the operations of the Islamic bank align with Shariah rules and principles. The job of Shariah auditors is very sensitive compared to any other audit because the findings of Shariah auditors serve as the basis for the Shariah board to form an opinion about the Shariah compliance environment of Islamic banks. The study will focus on the challenges of the competence of Shariah auditors in the Islamic finance industry and will draw conclusions using qualitative and quantitative methods. The paper will be divided into two parts: in the first part, researchers will collect data using survey methods and analyze it; in the second part of the study, interviews with experts will be included. The paper will be helpful for practitioners, policymakers, and specifically for the State Bank of Pakistan to enhance the Shariah compliance environment in the Islamic Finance Industry.

Key words: Islamic banking, Shariah governance, Shariah compliance, Shariah audit, International Shariah audit, External Shariah audit.

Introduction

The very first idea of Islamic Banking or interest-free banking began in Egypt at MIT GHAMR by Ahmad El Najjar in 1963. From 1963 until 2022, a reasonable increase in Islamic monetary institutions can be observed, which enhanced the interest of many stakeholders in the Islamic financial industry. The fundamental interest of the stakeholders is connected with the Shariah compliance climate of the IBIs. To gain the interest of this large number of stakeholders, a secure and efficient Shariah management system should be adopted by IBIs, which is only possible through sufficient and skilled Shariah reviewers in Shariah auditing, which also enhances the confidence of the stakeholders.

The recently employed Shariah management system was provided by SBP in 2018 with several corrections compared to the one provided in 2014 and 2008. The primary

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purpose of this framework is to strengthen the Shariah compliance climate and ensure that all the products, services, policies, transactions, and operations adhere to the defined Shariah principles. Furthermore, to ensure a fully secure risk management approach in Islamic Financial Institutions. Alongside Shariah guidelines, accounting and auditing standards should also be made mandatory in IFIs, such as AAOIFI.

AAOIFI is an Islamic international independent nonprofit corporate body that prepares accounting, auditing, governance, ethics, and Shariah standards for Islamic financial institutions and the industry, formed on February 26, 1990, in Algeria. It is supported by various institutional members, including central banks and regulatory authorities, financial institutions, accounting and auditing firms, and legal firms, from 45 countries.

Shariah Auditing is mainly divided into two primary categories as internal and external auditing (internal Shariah auditing and external Shariah auditing). It is to maintain the credibility of Islamic financial institutions. Established Islamic banks or conventional banks with Islamic branches and windows appoint a Shariah advisory board to oversee the bank's Shariah compliance.

All the decisions of BOD's, EM, and other regulatory bodies are dependent on the decisions of the Shariah board. Therefore, clear and unbiased reports, adequate disclosures, and transparency in Shariah auditing are mandatory requirements, which are only possible through competent and skilled Shariah auditors who are experts in their profession and can genuinely justify their roles and responsibilities.

Being a Shariah auditor is a specialized occupation compared to financial auditing. The Shariah auditor should have the necessary qualifications and competency to examine whether transactions comply with Shariah rules and principles. Despite the importance of Shariah audit qualification, there is, however, little guidance on how to train or groom qualified SARs. Previous studies lacked the training needed for staff with both qualifications, specifically "accounting and Shariah qualification," which makes the Shariah auditors incompetent and can have a significant impact on IBIs.

The objective of this paper is to examine the qualification and skills of Shariah auditors in Pakistan as envisioned in the SECP and SBP guidelines using qualitative methods. The review also highlights the role of accounting bodies in the preparation, proper implementation of Shariah audit manuals, and capacity building of audit staff in Islamic banks.

Literature Review

In a pioneering study, Khan (1985) presented the argument that conducting auditing in the context of Islamic economics differs from conventional auditing. Abdul Rahman (2007) argued that despite the expansion of the global Islamic banking and

finance business, Shariah auditors still lacked specialized academic and professional qualifications, highlighting the necessity and difficulties of conducting Shariah audits. Shariah auditing principles are well defined in the Shariah governance framework, ensuring that IFIs are required to guarantee that all activities are based on Shariah principles since they have a duty to do so. Conflicts that result in monetary and non-monetary losses could arise due to the absence of such a governance framework. As there is no standardized internal audit framework for Shariah, practitioners do not follow standardized Shariah audit procedures, creating challenges for industry participants when conducting Shariah audits. Most of the time, IFIs seem to mimic the regular conventional external audit program while placing greater emphasis on financial audits (Mahzan and Yahya, 2014).

The need for Competency Model

Most competency models are frequently utilized by the Human Resource Department (HRD) of reputable organizations, and scholars have long discussed the need for competency models in various disciplines. The majority of empirical studies have focused on the effectiveness of human resources competency models in organizations (Markus et al., 2005). Given that HRD is responsible for overseeing an organization's human resources operations, this condition is acceptable. How one views competency will determine the justification for employing the competency approach (Hoffmann, 1999). The primary justification for using such metrics would be to enhance or modify human performance if competency represents performance (Sutton and Watson, 2013).

However, if competency is seen as a yardstick for standards or performance quality, it makes sense to standardize skills, implement modifications, raise the bar for performance quality, as well as define minimal performance criteria. Similarly, if competency refers to a person's fundamental characteristics, the goal is to identify the curriculum or subject matter that will ultimately result in optimal performance (Hayes et al., 2000). In the context of SAR in Pakistan, a competency model is necessary as it serves as a guide for the human resources departments of the IFIs in their hiring and promotion processes, ensuring that only qualified individuals will be chosen.

Developing the Competency Model

According to Boyatzis (1982), creating a competency model involves "combining the findings of diverse competencies and clusters into an integrated competency model, analogous to putting together a jigsaw puzzle." Competency models often classify individuals' competencies into groups. These competency models typically consist of a list of personal qualities to be applied in the HR system.

A functional competence model must include examples to show how a particular competency is used in the workplace. In addition to serving as a human resource tool

that uses defined capabilities necessary for optimal performance (Hoffmann, 1999; Lucia & Lepsinger, 1999; Mirabile, 1997), they recommended focusing on specific behaviors that can be learned or altered through training, coaching, or other developmental strategies during the data collection process for constructing a competency model. An effective human resource competency model needs to be created so that it can list or define the abilities that businesses' human resources can act upon with confidence (Dass & Parker, 1999). Competency modeling promotes organizational transformation initiatives by creating widespread, systematic support for future-focused competencies.

To create a competency model, Lucia and Lepsinger (1999) provided four processes, including defining objectives and scope, clarifying implementation goals and standards, developing an action plan, and identifying personnel at various performance levels (Lucia and Lepsinger, 1999). The study's approach to the problem of creating a competency model is interpretivist or constructivist. On a metaphysical level, interpretivist approaches this problem through an inductive line of reasoning because competency is a behavioral issue. Instead of being a singular occurrence as positivists claimed, the competency issue is a component of social realities that can be understood in various contexts (Merriam, 2009).

The basis for the competency epistemology is subjective measurement or exploratory in character, which can only be obtained by examination or observation rather than generalization based on random surveys. Since it is largely thought to be the best method due to its exploratory nature, this study is an attempt to understand the requirements for a competent SAR by utilizing a purely qualitative approach. It also aims to extract the rich data required to address and justify the research concerns provided (Creswell, 2007).

Shariah Auditing

A periodic evaluation, known as a "Shariah audit," is one that is periodically carried out with the primary goal of providing strong and effective internal control over the IFI's business operations. It serves as an independent evaluation and objective assurance.

In addition, Hameed (2008) defined Shariah auditing as:

“A systematic process of objectively obtaining and evaluating evidence regarding assertions about socioeconomic, religious and environmental actions and events in order to ascertain the degree of correspondence between those assertions and Sharia (Islamic Law), communicating the results to the users.”

Based on the description provided above, it is evident that Shariah auditing takes a different approach than conventional auditing, especially concerning the issue of Islamic organizations upholding Shariah principles.

Why is it needed?

Shariah auditing, often known as Islamic religious auditing, monitors how well IFIs adhere to Shariah law. The definitions provided above make it clear that the purpose of a Shariah audit is to confirm that an IFI complies with Shariah in all relevant aspects. Yes, this is the primary goal of a Shariah audit. The objectives of auditing were explicitly stated in what AAOIFI released in 2010. The primary responsibility of Shariah auditors is to ensure whether all the operations, products, services, and transactions of Islamic Financial Institutions conform to defined Shariah rulings and fatwas or not.

Features of Shariah Auditing

The following are some qualities of auditing from an Islamic perspective that are noteworthy:

- Islamic auditing principles are determined by Islamic jurisprudential sources, including the Holy Qur'an and Sunnah. These rules are flawless, unchanging, and all-encompassing.
- Auditing is also founded on principles, including confidence in Allah, honesty, keeping commitments, cooperation, and forgiveness. In this context, Allah declares: "Allah bans all disgraceful crimes and injustice and receives rebuke. He requires justice, doing well, and giving kinsfolk" (Surat al-Nahl, verse: 90).
- It is founded on the conviction that Allah alone is the sole owner of all things and the idea that there will be an opportunity for responsibility to Allah on the morrow.
- Islamic auditing stays away from bad and illegal trades and only works with legal transactions.
- Islamic auditing focuses on the human conduct of those employed in businesses and encourages and inspires them to follow the correct path in accordance with Islamic law.
- The Islamic auditing framework is more comprehensive, encompassing both spiritual and material dimensions, and is relevant to all facets of life.

Shariah Auditing in terms of Quran

Islam does not acknowledge the distinction between worldly and spiritual issues and regards trade as a moral matter that must adhere to Shariah law. Therefore, Shariah principles must be followed in all commercial and financial activities by Islamic banks

and other Islamic business entities. The Qur'an contains verses that address the subject of auditing. As stated by Allah (swt) in the Qur'an:

“Then as for he who is given his record in his right hand, He will be judged with an easy account, and return to his people in happiness.” (Surat al-Insyiqaq, verses: 6-9).

“And indeed, [appointed] over you are keepers, Noble and recording; they know whatever you do.” (Surat al-Infithar, verses: 10-12).

“Surely Allah takes account of all things” (Surat al-Nisa, verse: 82)

Shariah Auditing in terms of Hadith

Reviewing or auditing riba-based accounts is prohibited because it involves documenting riba, remaining silent about it, and giving it your approval. The Prophet of Allah cursed the person "who consumes riba and the person who pays it, the person who records it, and the two who witness it, and he said: They are all the same." Saheeh (1598).

Role of Shariah Auditors in Islamic Banks:

“The role of Shariah auditors is to provide independent assurance as the third level of defense to Islamic banking operations. They do not only look at the validity of transactions, but also at the internal control element to see if it is effective and efficient enough to mitigate any potential Shariah breaches.” (CSO-FFIB).

The Shariah auditor, according to one of the responders who is also a member of the ShC of DFI, should only concentrate on their tasks in the Shariah audit and cannot mix with the other functions. The main goal of this strategy is to ensure that they can identify a wide range of problems, particularly concerning Shariah. Her argument unquestionably has a foundation and accomplishes the following:

“When Shariah auditors conduct the Shariah audit, they cannot audit the other things, but they should only focus on Shariah compliance. If they do that, then, maybe they will be able to detect so many issues and findings in the organizations” (SHC-DFI).

In conclusion, it is agreed from the interviews that the Shariah auditor shall have the following functions and responsibilities:

- To guarantee the investors and partners that every one of the organizations and activities follows Shariah,
- To act as the third line of safeguard,

- To investigate the interior control component to determine if it is viable and proficient enough to prevent any conceivable Shariah breaches,
- To emphasize Shariah compliance to identify many issues, and
- To advise the ShC on the tasks by providing a clear and better comprehension of the activities.

Stakeholders Perspective on Audit Quality

After reviewing the current literature, we found that different stakeholders have developed and presented diverse opinions on audit quality.

- The first viewpoint is that of the general public or the users, who judge the quality of an audit based on its final product since it influences their choice to invest and other business decisions (Ianniello and Galloppo, 2015; Holt and DeZoort, 2009). In light of this, it may be said that audit quality has been attained if the auditor finds and discloses any substantial misstatements (Deangelo, 1981). ASIC, an agency of the Australian Securities and Investments Commission, concurs that the financial statements must not include any major misstatements for the audit to be considered successful (ASIC, 2017).
- On the other hand, examiners believe that the review is a coordinated undertaking done with a thorough and systematic interaction. In this way, adhering to the effective review plan sufficiently is enough to achieve audit quality (Christensen et al., 2016). According to this perspective, if the auditor has followed the review plan, risk assessment methods, and audit procedure, audit quality is achieved even if a material error is not identified during the process. Auditors support their viewpoint with the argument that audit engagement provides reasonable assurance of adequate appropriate audit evidence (IAASB, 2014) rather than absolute assurance.
- The third perspective is from the audit firms. They believe that audit quality has been achieved if it can be successfully defended in court against legal action or malpractice claims. Litigation indicates poor audit quality (Franz et al., 1998). To prevent negative outcomes, auditors exercise greater care when there is a significant risk of a lawsuit (Sun and Liu, 2011, Peecher and Piercey, 2008).

Factors Affecting the Competency of Shariah Auditors

As previously noted, assessing audit quality is a challenging task with many facets, both theoretically and practically. Professional groups and individuals have

constructed their frameworks for classifying the characteristics of audit quality in terms of inputs, process, outcome, and context. Independence, confidentiality, qualifications, inconsistent declarations and Shariah decisions, audit scope and timeliness, Shariah audit evidence, audit programs and processes, and an independent regulating body are among the issues faced by Shariah auditors.

There is a wealth of research on the variables that influence audit quality, either directly or indirectly, individually or collectively. We will go through a few of the key elements noted in the literature below:

Specific Knowledge and Experience

One reason is that auditors develop industry-specific abilities due to repeating the same tasks (Bonner and Lewis, 1990; Frederick and Libby, 1986), which positively influences their performance (Beck and Wu, 2006). Additionally, this experience enhances their capability to identify internal control deficiencies (Rose-Green, Huang, and Lee, 2011; Hammersley, 2006) and fraud and errors (Sarwoko and Agoes, 2014). Without understanding the elements of Shariah non-compliance risk, a Shariah auditor cannot assess and examine the sufficiency, efficiency, and effectiveness of Shariah controls at branches and operational units. However, the shortage of such Shariah auditors and consistent audit officials is one of the primary challenges for the industry (Ali and Kasim, 2019).

Absence of Expert Suspicion

Some studies explored the impact of professional skepticism on audit quality and found that a lack of professional skepticism leads to audit deficiencies (Favere-Marchesi and Emby, 2018) and audit failures (IFIAR, 2016). Hence, there is a positive correlation between professional skepticism and audit quality (Chen et al., 2009). Similarly, experts found a positive connection between auditors' professional judgment and audit quality.

Auditor Independence

To be independent, the auditor must be mentally credible; to be recognized as independent, they must be free from any obligation to or interest in the client, its management, or its owners. Auditor independence is one of the key factors affecting audit quality. Several factors, including client significance, auditor tenure, non-audit fees, atypical audit fees, and audit market concentration, have been taken into consideration by several research studies. Both higher audit fees and lower audit fees compared to standard fees are viewed as threats to the independence of the auditor and may result in unsatisfactory audit quality. The prevalent perception is that non-audit fees have an impact on auditor independence.

Inability to Interpret the Audit Results

If Shariah auditors are unable to deliver comprehensive, honest, and timely reports with proper disclosures, it raises serious concerns about their competence. This may occur for various reasons, such as lack of data, insufficient information, inadequate resources, inappropriate expertise, and so on. All of these factors can make it challenging for Shariah auditors to understand or interpret the data.

According to Shariah auditing requirements, despite the AAOIFI's best efforts, the audit's focus is on the financial statements' dollar amounts rather than a more comprehensive concept of Shariah auditing that incorporates Shariah's objectives. Second, the question arises: who is the ideal candidate to perform the audit in terms of the "actual" owner? The Shariah audit function is divided among the external auditor, the Shariah Board, the internal Shariah reviewer, and the Audit and Governance Committee in accordance with AAOIFI norms. The third concern is the independence of the Shariah Board, which also has the authority to approve products for release onto the market and to conduct audits and reviews of the relevant IFI's compliance with Shariah law.

Concerns about the overall competency level of each Shariah Board member, who appear to lack technical understanding of banking and finance, were raised in another study by Haridan et al. (2018). The absence of competent Shariah Board members who lack the necessary understanding might harm Shariah governance and undermine public confidence. To ensure an efficient Shariah governance process in the IFIs, the competency of the Shariah Board members is essential. The study made it clear that the makeup of the Shariah Board members—both Muslims and non-Muslims—could enhance their ability and capacity to offer high-quality Shariah assurance.

Table 1: Competency Requirement of Shariah Auditors by Different Regulatory Bodies

Regulatory Bodies	Competency\Qualification of Shariah Auditors
SBP	<p style="text-align: center;">2008</p> <p>SBP published the regulations for IBI Shariah compliance in 2008. The internal Shariah audit was to be implemented by the IBIs.</p> <p style="text-align: center;">2015</p> <p>All IBIs were instructed to incorporate external Shariah audit after the SBP released the SGF in 2015, further strengthening the Shariah compliance environment there. However, the SGF didn't define the qualifications or experience of external Shariah auditors. SGF 2015 appears to grant financial audit firms the freedom and discretion to appoint any auditor they deem suitable to ensure the Shariah compliance of Islamic banks' operations and modes. Audit firms that possess a workforce of qualified and certified auditors for the financial audit of any entity have the discretion to manage the external Shariah audit.</p> <p style="text-align: center;">2018</p> <p>The SBP updated the Shariah governance structure in late 2018. An explanation was provided regarding the qualification, appointment, and competency of external Shariah auditors, along with guidelines for enhancing the capability of those who engage external Shariah auditors, in addition to other changes to the Shariah governance structure.</p>

<p style="text-align: center;">SECP</p>	<p>SECP has also provided Shariah governance guidelines, which state that every Shariah-compliant company offering Shariah-compliant securities will undergo external Shariah audit for each financial year. This audit may be conducted by the existing external auditors or an independent external Shariah auditor. These guidelines are in accordance with Section 247 of the Companies Act.</p> <p>More specifically, the guidelines mention that;</p> <p style="text-align: center;"><i>"The audit firm should ideally have expertise in Islamic finance. The scope of the external Shariah audit will encompass an independent and objective assessment of operations' compliance with Shariah"</i> (SECP 2018).</p> <p>Considering the discussion and guidelines provided by SECP, it can be concluded that the issue is not adequately addressed due to the fact that referring to the appointment rules of an auditor mentioned in Section 223 and 247 of the Companies Act for the appointment and responsibilities of a Shariah auditor, specifically an external Shariah auditor, is an inaccurate analogy. This is because there is a significant difference between the responsibilities of a financial auditor and a Shariah auditor, which outlines differences in qualification and expertise requirements between the two types. Therefore, it is not appropriate to mix financial audits with Shariah audits based on a common term "audit" in both contexts. It appears that the issue is not sufficiently addressed by SECP.</p>
<p style="text-align: center;">AAOIFI</p>	<p>Regarding the qualifications of the Shariah auditor, AAOIFI has proposed a solution.</p> <p style="text-align: center;"><i>"The auditor must be familiar with shariah laws and guidelines. The auditors shall not be required to provide an interpretation of these rules and principles because he would not have the same level of knowledge as SSB members."</i></p> <p>It is clear that AAOIFI has only briefly touched on the issue and has not provided any specific qualifications for Shariah auditors in general or for external Shariah auditors in particular.</p> <p>However, it is an essential requirement for audit work to have a thorough and comprehensive understanding of the</p>

	<p>interpretations of rules and principles to gain a broader perspective on every financial aspect.</p> <p>Therefore, a financial auditor may partially meet the criteria for a Shariah auditor, but the absence of Shariah knowledge renders them unsuitable and unauthorized for the role.</p>
<p>Bank Negara Malaysia Shariah Governance Framework</p>	<p>The following instructions have been issued by BNM for auditors:</p> <p><i>"The task must be carried out by internal auditors who have received sufficient training and understanding in shariah. Additionally, the internal auditors may use the IFI'S shariah officers' knowledge to conduct the audit as long as the audit's neutrality is not affected "</i> (BNM, 2009).</p> <p>The guidelines for internal Shariah audit and auditors represent only a small part of the entire Shariah audit process because the internal Shariah auditor's main focus should be on preparing and organizing the material for external Shariah auditors.</p>

Appointment Standards for Pakistan's Shariah Auditors

The FAPC offered by SBP includes the necessary criteria for selecting or hiring an external Shariah auditor. The guidelines are as follows:

"Shahadat ul Alamiya degree from any recognized board madaris with min 70% marks and bachelor's degree with a minimum of second class, or, postgraduate in khulliyatu shariah, or kulliya Ussuluddin, LLM Shariah with a minimum 3 CGPA or equivalent from any recognized university"

Additional requirements or considerations to take into account when hiring or selecting any Shariah auditor or external Shariah auditor include the candidate's track record in socioeconomic and financial dealings, solvency and financial integrity, honesty and reputation, potential conflicts of interest, and compliance with the declaration of secrecy as per section 33-A of the Banking Companies' Ordinance 1962.

Discussion and Analysis

In contrast to a financial auditor, an external Shariah auditor possesses compassion. The external auditor's role in financial audits is to gain reasonable confidence that there are no major misstatements in the financial statements as a whole, whether due to fraud or error. The external Shariah auditor is responsible for expressing an opinion

about the compliance of all contracts and transactions with Shariah laws and regulations.

All of the aforementioned organizations agree that Shariah auditors need to have an appropriate working understanding of Islamic Banking (IB) given the nature of their job.

The State Bank of Pakistan (SBP) recommended that audit companies select Shariah experts based on "shahadat almiyah fil uloomal arabia wal islamia" or "takhasus fil fiqh wal ifta or Shariah background," from the standpoint of Pakistan. However, these Shariah experts do not meet the required standards for knowledge and expertise in accounting and auditing. However, the Securities and Exchange Commission of Pakistan (SECP) has provided auditors certified by the Institute of Chartered Accountants of Pakistan (ICAP) or the Institute of Chartered Management Accountants of Pakistan (ICMA of Pakistan) as a more workable approach. This is because Islamic Banking (IB) and finance-related topics are not currently covered in the curricula of reputable accounting institutes that produce qualified accountants and auditors.

Therefore, it is advisable that the SBP review the qualification criteria (FAPC) for Shariah auditors to strengthen the Shariah compliance environment in Islamic Banking (IB) and the finance industry and to reduce the risk of Shariah non-compliance. This is because Shariah scholars lack sufficient knowledge of accounting and finance, while auditors lack Shariah knowledge.

Recommendations

- When selecting internal and external Shariah auditors, the above-described detailed FAPC must be carefully considered. However, although FAPC offers features for the recruiting process of Shariah-related positions, it leaves many questions unanswered. By neglecting to mention one of the key components of academic education, namely the understanding of economics, financial accounting, and auditing principles, the academic qualification specified in FAPC leaves a substantial gap. Consequently, there is a major shortage of internal and external Shariah auditors, which negatively affects their performance as well as that of Islamic banks as a whole.
- An auditor should maintain objectivity, independence, and honesty. They are required to report what they observe.
- Auditors should adhere to the technical standards of their profession and continuously work to raise their level of expertise and the quality of their work.
- Auditors must always treat their clients fairly and impartially and take the proper professional precautions in line with their duties.

- Auditors should act in a way that fosters positive relationships among members and enhances the standing of the profession as a whole.
- As auditing is a social role, auditors should always perform their work in the public interest.

Conclusion

Auditing is a crucial duty for any organization. The central figure and position of an organization cannot be ascertained if it is not done successfully and efficiently. The Holy Qur'an and Hadith may be the finest sources of guidance for conducting efficient and successful audits. An individual who is knowledgeable about the Qur'an and conventional auditing techniques may perform it competently. Islamic financial institutions are flourishing and expanding rapidly nowadays, making a strong case for the importance of Islamic auditing. However, for religious people, more thorough works are required. References to specific verses of the Qur'an, Sunnah, and other divine messages should be compiled separately. Efforts should be made to cultivate a godly mindset. Course curricula that are based on divine messages and how they are applied to various areas, such as accounting, auditing, and others, should be developed through study and research.

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