

# Impact Of Shariah Audits On Financial Stability And Risk Management

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**Abstract:** This paper explores the role of Shariah audits in enhancing financial stability and mitigating risks within Islamic financial institutions. Shariah audits are essential in ensuring compliance with Islamic financial principles which prohibit activities such as interest, speculation, and investment in unethical sectors. This study analyzes the impact of Shariah audits on the operational and financial health of Islamic banks by examining audit processes, compliance levels and their correlation with financial stability and risk management outcomes. The research uses a mixed-methods approach to draw on existing literatures, financial data and expert interviews to provide a comprehensive understanding of how Shariah audits contribute to a more stable and resilient financial system. The findings highlight the importance of robust Shariah governance in ensuring trust and sustainability in Islamic finance.

## Research Highlights:

- **Importance of Shariah Audits:** Shariah audits are essential in Islamic financial institutions (IFIs) to ensure compliance with Islamic principles, safeguarding ethical and legal integrity in all financial practices.
- **Contribution to Financial Stability:** Shariah audits enhance financial stability by prohibiting speculative activities, interest-based transactions, and unethical investments, thereby reducing systemic risks and financial crises impacts.
- **Role in Risk Management:** The Shariah audit framework strengthens operational, credit, and market risk management by ensuring asset-backed financing, ethical governance, and transparency in operations.
- **Enhancing Governance Structures:** Shariah audits reinforce governance frameworks within IFIs, promoting accountability, reducing misconduct, and improving resilience during financial instability.
- **Alignment with ESG and Sustainable Finance:** By directing investments towards socially responsible and ethical sectors, Shariah audits align closely with ESG principles and sustainable development goals, fostering long-term value creation.
- **Significance for Stakeholders:** Findings highlight that rigorous Shariah audits strengthen stakeholder trust assuring investors, regulators, and customers of compliance while mitigating reputational, legal, and operational risks.
- **Recommendations for Practice:** The study suggests enhancing Shariah audit practices through stronger integration with risk management frameworks, capacity-building for auditors with dual expertise (finance and Shariah law), and continuous alignment with international regulatory standards.

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## INTRODUCTION

Financial stability and risk management are critical concerns in any financial system as highlighted by the global financial crisis of 2007-2008 which stressed the need for robust risk management and financial stability measures (Brunnermeier, 2009). The financial system has therefore evolved over a long time ago with various frameworks and auditing practices aimed at enhancing transparency, accountability, and efficiency. Among these frameworks is the Shariah which has emerged as an important component in Islamic finance to cater to the unique requirements of Shariah compliance (Shafii, Abidin, & Salleh, 2015).

The principles of Islamic finance are guided by divine laws which prohibits *riba*, excessive uncertainty, and gambling, while also mandating profit-and-loss sharing, ethical investments as well as asset-backed financing. This distinct framework brings about a specialized form of auditing to ensure all financial transactions and operations conform with Shariah principles (Lewis, 2005). On the side of conventional financial system, its auditing process mainly focus on financial statements and adherence to a set of generally accepted accounting principles (GAAP) or international financial reporting standards (IFRS), in contrast to Shariah audits that has additional layer of compliance in other to ensure that financial practices are consistent with Islamic ethical and legal standards (Yaacob & Donglah, 2012).

The need for rigorous Shariah audits becomes increasingly important as Islamic financial industries continues to expand. This is very crucial for these industries to maintain their integrity and trustworthiness thus assuring their stakeholders, investors, regulators, and customers of strict adherence to Shariah principles. This is also important for the industries to contribute to the broader goal of financial stability and risk management as well as promoting ethical and responsible financial practices. Moreover, mitigating risks associated with non-compliance, reputational damage, and financial mismanagement in Islamic banks can be actualized by integrating Shariah auditing within the risk management framework (Abdullah & Rahman, 2017). These frameworks are established and guided by many international regulatory bodies like the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (Archer & Karim, 2007).

The aims and objectives of this research include: To evaluate the effectiveness of Shariah audits in maintaining financial stability within Islamic financial institutions, to analyze the role of Shariah audits in risk management practices, to assess the correlation between Shariah compliance and financial performance in Islamic banks, to examine the audit processes employed by Islamic financial institutions to ensure Shariah compliance, to identify the key areas where Shariah audits influence financial stability and risk management, to explore the relationship between Shariah audit outcomes and the financial performance of Islamic banks, to provide recommendations for enhancing Shariah audit practices to support financial stability and risk management.

This research is significant as it addresses the critical role of Shariah audits in safeguarding the principles of Islamic finance, which is gaining prominence globally. Understanding the impact of Shariah audits on financial stability and risk management is crucial for stakeholders including regulators, financial institutions and investors to ensure the integrity and sustainability of Islamic finance. The findings contribute to the existing literature by highlighting the importance of comprehensive Shariah audit practices and offering insights into their implications for financial stability and risk management.

## METHOD

This study employs a mixed-methods approach to achieve a holistic understanding of the impact of Shariah audits.

**Literature Review: A thorough review of existing literature on Shariah audits, financial stability, and risk management in Islamic finance will be conducted to establish a theoretical foundation.**

A conventional financial audit is simply a systematic examination of an organization's financial statements and operations conducted by an independent auditor with the purpose of ensuring compliance and transparency in financial reporting while providing stakeholders with a reliable representation of the

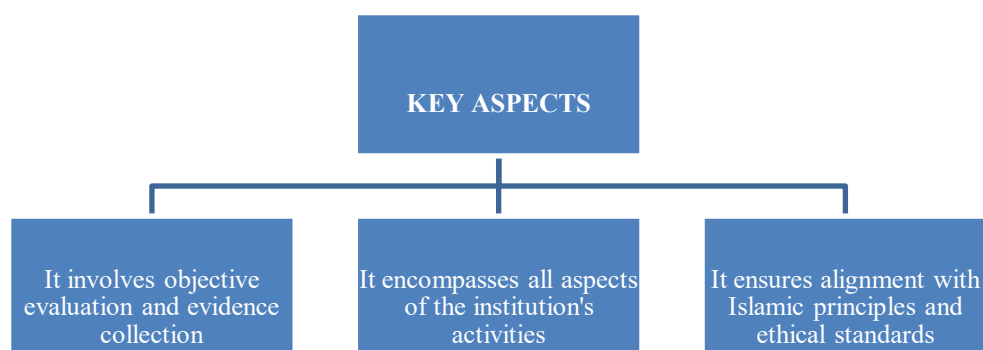
entity's performance. (Whittington & Pany, 2018). This type of audits is like the Shariah audit which also seeks to validate the accuracy and fairness of financial records in the institutions. Auditors are to ensure that financial statements are free from material misstatements by making a detailed examination of financial records to confirm that all transactions are recorded appropriately and also reflect the true financial position of the institution (Arens, Elder, & Mark, 2019). Compliance is a key objective of conventional financial audits, auditors would verify that the institutions adhere to applicable accounting frameworks such as GAAP or IFRS which provide standardized guidelines for recognizing, measuring, presenting, and disclosing financial information across different entities (PWC, 2020). These auditors would ensure compliance with relevant laws and regulations including tax laws, securities regulations and some guidelines that are specific to the institution (ISA, 2019). These auditors would also assess the effectiveness of the institution's internal controls over financial reporting by identifying weaknesses as well as providing relevant recommendations for the institution's improvement. (COSO, 2013).

Furthermore, risk management is another critical aspect of conventional financial audits. Auditors would make a thorough identification and assessment of risks related to financial reporting with a focus on areas with a higher likelihood of material misstatement. They will tailor their approach to effectively address significant risk areas (AICPA, 2019). Moreover, the audit process does comprise several stages starting with planning, where auditors meet with management to understand the scope of the audit, the business environment and specific risks. During next is the fieldwork stage where auditors test the company's internal controls to ensure their proper functioning and perform substantive tests on account balances and transactions to verify their accuracy, including confirming receivables, verifying inventory and examining financial records and documentation. The third stage is the evaluation which involves analyzing test results and procedures performed, with auditors making professional judgments in areas requiring subjective evaluation. Reporting is the final stage which includes issuance of an audit report with the auditors' opinion on the financial statements and providing a management letter that outlines significant weaknesses in internal controls along with recommendations for improvement (Arens, Elder, & Mark, 2019).

**Qualitative Analysis: In-depth interviews with Shariah auditors, financial experts, and regulatory authorities will be conducted to gain insights into the audit processes and their impact on financial stability and risk management.**

Case studies of selected Islamic financial institutions will be used to illustrate the practical implications of Shariah audits. Shariah auditing has become a pivotal area within Islamic finance, it involves the systematic process of evaluating the operations and transactions of Islamic financial institutions in order to verify their adherence to Shariah law. According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Shariah review involves examination of contracts, agreements, policies, products, transactions, financial statements and other relevant documents to ensure they conform to Shariah law (AAOIFI, 2010). It extends to ethical and moral compliance based on the teachings of Islam unlike the conventional audits that primarily focus on financial accuracy and regulatory compliance.

However, defining Shariah audit poses a challenge due to its lack of a universally accepted framework that encompasses all aspects of an institution's operations. Islamic financial institutions are operating in diverse regulatory environments and under varying interpretations of Shariah law. This diversity requires a flexible approach which can adapt to different contexts while maintaining a strong commitment to Islamic principles. The necessity of Shariah audits also stems from the requirement to serve the Muslim community, thus, it prioritizes compliance with Islamic laws over conventional financial practices (Kasim & Sanusi, 2013). As such, these audits are executed according to guidelines established by Islamic financial bodies such as the AAOIFI, which provides comprehensive frameworks for both internal and external Shariah audits (Yahya & Mahzan, 2012).



### Scope of Shariah Audit

The scope of Shariah auditing is wide-ranging as it covers various types of audits to ensure comprehensive compliance with Shariah:

- Financial Statement Audit: Assesses whether the financial statements are prepared in accordance with Shariah principles and relevant financial reporting frameworks.
- Performance Audit: Evaluates the economy, efficiency, and effectiveness of the institution's resource utilization, ensuring alignment with Islamic principles.
- Tax Compliance Audit: Ensures that tax practices comply with local regulations and Shariah.
- Environmental Audit: Reviews the institution's environmental impact and adherence to Islamic environmental ethics.
- Social Audit: Evaluates the institution's social responsibility and ethical practices according to Shariah guidelines.
- These audits collectively ensure that Islamic financial institutions not only meet financial and regulatory requirements but also adhere to the ethical and moral mandates of Shariah law.

### Process of Shariah Audit

The process of Shariah audit is designed into several stages to ensure thorough compliance:

- Planning Review Procedures
  - Understanding Operations: This comprises an In-depth analysis of the institution's products, size, branches, and overall operations.
  - Fatwa Review: This contains compilation of relevant fatwas, rulings, and guidelines issued by the Shariah Supervisory Board (SSB).
- Executing Review Procedures
  - Document Examination: The auditors are meant to review contracts, agreements, and other transaction documents to ensure shariah compliance.
  - Transaction Verification: The auditors will ensure that all transactions adhere to Shariah-approved procedures.
  - Consultation with Experts: The internal auditors will collaborate with external auditors and Shariah advisors for comprehensive insights.
- Documenting Conclusions and Reporting
  - Report Preparation: This involves documentation of findings and preparing reports for shareholders and management.
  - Quality Assurance: This involves Implementation of quality control procedures to ensure thorough and accurate reviews.

### Standards and Guidelines

Shariah auditing is governed by a comprehensive set of standards and guidelines to ensure consistent and thorough reviews:

- AAOIFI Standards: Provide a framework for Shariah audits, including guidelines for Shariah Supervisory Boards, internal Shariah reviews, and governance principles.

- International Standards on Auditing (ISA): Offer guidelines for financial statement audits that can be adapted for Shariah compliance audits.

### **Differences Between Shariah Audit and Conventional Financial Audit**

Despite some methodological similarities in Shariah auditing and conventional financial auditing, the two also differ in some of their fundamental objectives, criteria, and scope. These differences are highlighted below.

- **Scope of Audit**

Conventional financial auditing focuses on providing an independent assessment of an entity's financial statements. The primary goal is to determine whether these statements present a true and fair view of the company's financial performance and position according to established accounting frameworks such as International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP) (International Auditing and Assurance Standards Board [IAASB], 2020). The audit typically covers financial records, transactions, internal controls, and disclosures to ensure compliance with legal and regulatory requirements (IFRS Foundation, 2021). In contrast, Shariah audit extends beyond the financial scope to encompass a comprehensive review of an institution's adherence to Islamic law. This includes the evaluation of business practices, contracts, products, and the overall impact of the institution's activities on society and the environment (Karim & Moha Asri, 2019). The objective is to ensure compliance with Shariah principles which govern ethical behavior and prohibit interest and disallow investments in certain industries deemed haram such as alcohol and gambling (Kasim & Sanusi, 2013).

- **Criteria for Compliance**

The criteria for conventional audits are established by financial accounting and auditing standards, such as those issued by the International Auditing and Assurance Standards Board (IAASB). These criteria emphasize the accuracy, completeness, and fairness of financial information (IAASB, 2020). Auditors assess whether the financial statements are free from material misstatement, whether due to fraud or error, and adhere to the relevant accounting standards (American Institute of Certified Public Accountants [AICPA], 2018). However, Shariah audits are guided by Islamic principles and standards set by organizations like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Compliance criteria include adherence to Shariah principles in all business dealings, likewise ensuring that financial activities do not involve interest, excessive uncertainty (*gharar*), or investments in forbidden sectors (AAOIFI, 2017). The criteria also involve adherence to fatwas issued by Shariah Supervisory Boards (SSBs), which provide specific rulings on financial and operational activities (Yahya & Mahzan, 2012).

- **Nature of Assurance**

The objective of conventional auditing is to provide a high level of assurance that the financial statements are accurate and reliable. This is expressed through an audit opinion which can be unqualified (clean), qualified, adverse, or a disclaimer of opinion, based on the findings (AICPA, 2018). The assurance is also focused on the regulatory compliance of the entity. Shariah audits on its own side tends to provide a more comprehensive form of assurance. In addition to its financial accuracy, there will be assurance that the institution's activities are Shariah compliant (Khan & Ahmed, 2018).

- **Role of Auditors**

The role of conventional auditors is to independently verify the financial statements prepared by the company's management. They gather evidence, assess risks, and perform analytical procedures to form an opinion on the financial statements (AICPA, 2018). They must adhere to professional standards of independence in order to ensure the credibility of their assessments (IFRS Foundation, 2021). On the other hand, Shariah auditors are responsible for ensuring that all aspects of the institution's operations comply with Islamic law. This role involves close collaboration with Shariah scholars and the Shariah Supervisory Board, who provide guidance on Islamic principles (Khan & Ahmed, 2018). Shariah auditors must have expertise in both conventional auditing practices and Islamic jurisprudence to effectively assess compliance.

- **Independence and Qualifications**

Shariah auditors must balance independence with close collaboration with the Shariah Supervisory Board. They need to be knowledgeable in both auditing practices and Islamic jurisprudence (*fiqh al-muamalat*). This dual expertise is essential for ensuring compliance with both financial and Shariah standards (Kasim & Sanusi, 2013). The potential for conflicts of interest and the need for comprehensive knowledge highlight the unique challenges faced by Shariah auditors (Yahya & Mahzan, 2012). As for the conventional auditors,

they are required to maintain strict independence to ensure objectivity. They must possess professional qualifications such as Certified Public Accountant (CPA) and adhere to standards of professional conduct and competency (AICPA, 2018).

## RESULTS AND DISCUSSION

### **Impact of shariah audit on financial stability**

Shariah audit is integral to the functioning of Islamic financial institutions (IFIs) as it plays a crucial role in promoting financial stability. It helps to maintain the ethical and religious integrity of financial operations which, in turn, enhances transparency and sustainability in financial systems. These audits build stakeholder confidence by making sure that the financial practices align with Islamic ethical standards, thus, fostering trust and commitment to Shariah-compliant investments (Kasri & Kassim, 2009). It also plays a fundamental role in mitigating financial risks by preventing practices that could lead to legal and reputational damages of Islamic financial institutions, thus safeguarding the financial stability of these institutions. Effective risk management is a fundamental aspect of financial stability which is promoted through Shariah audits.

This conservative approach to risk management minimizes exposure to high-risk activities and ensures that financial transactions are grounded in real economic activities thereby contributing to a more stable financial environment. Empirical evidence from the Islamic finance industries indicates that institutions adhering to Shariah principles are always found of demonstrating greater resilience during financial crises due to their conservative risk profiles (Kayed & Hassan, 2011).

Furthermore, Shariah audits encourage investments in sectors that contribute positively to society and the economy at large by aligning financial activities with sustainable development goals. It ensures that financial resources are directed towards socially responsible and sustainable ventures by prohibiting unethical investments such as industries dealing in gambling, alcohol, and weapons, (Ali & Al-Ali, 2020). This ethical orientation fosters a more stable and sustainable financial system by promoting long-term value creation. Additionally, Shariah principles align closely with Environmental, Social, and Governance (ESG) criteria that are recognized as crucial for financial stability. Compliance with these principles can only be enforced through Shariah audit. (El-Komi & Croson, 2013).

More so, Shariah audits play a crucial role in strengthening governance and regulatory frameworks within Islamic financial institutions this could be observed in the struggle of these institutions to ensure that financial practices comply with both Islamic law and national financial regulations. This audit will therefore enhance corporate governance frameworks that lead to greater accountability and reduced potential for misconduct. This robust governance framework will eventually promote sustainable business practices that supports long-term financial stability. Strong governance structures that are facilitated by Shariah audit have been shown to improve financial performance and stability in many countries (Grais & Pellegrini, 2006).

Finally, in times of financial crises, Shariah audits do foster resilience by reducing exposure to some systemic risks. The prohibition of interest-based transactions and speculative activities inherent in Shariah principles minimizes the likelihood of financial bubbles and crises. Historical evidence, such as from the 2008 financial crisis has indicated that Islamic financial institutions which are guided by Shariah principles and rigorous auditing, were less affected due to their conservative investment approaches and ethical risk management strategies (Čihák & Hesse, 2010). By promoting ethical conduct and reducing systemic risks, Shariah audits contribute significantly to the overall stability of the financial sector as well as maintaining a solid ethical foundation that supports long-term sustainability and stability.

### **Impact Of Shariah Audit On Risk Management**

Shariah audit is also a key success player when it comes to risk management framework of Islamic financial institutions. The audit structure significantly influences their approach to identifying, assessing, and mitigating risks. Unlike conventional audits that primarily focus on financial risks and regulatory compliance, Shariah audits ensure that all financial activities align with Islamic principles.

One of the key impacts of Shariah audit on risk management is the enhancement of operational risk management. By scrutinizing contracts, agreements, and financial transactions to ensure Shariah compliance, the audits tend to identify and mitigate risks associated with non-compliance such as reputational damage, legal penalties, and financial losses. This rigorous review process enhances the transparency and reliability of financial operations which is very crucial for maintaining reducing

operational risks (Hasan & Chachi, 2005). The audit framework also enforces stringent guidelines on ethical conduct and corporate governance which will further strengthening the operational risk management framework (Chapra, 2008).

Additionally, Shariah audits also significantly contribute to managing credit risk in Islamic financial institutions. By ensuring that all financial transactions adhere to Islamic principles, Shariah audits promote a conservative approach to lending and investment. For instance, Shariah-compliant financing requires that financial transactions be backed by tangible assets and prohibits interest-based lending which in turn helps mitigate credit risk by reducing the likelihood of default and ensuring that lending is based on the ability to generate real economic value (Ahmed, 2009). This asset-based financing model aligns the interests of the lender and the borrower likewise reducing the risk of credit defaults, thus enhancing the overall stability of the financial institution (El-Gamal, 2006).

Finally, Market risk is another area where Shariah audits have a profound impact. Shariah-compliant financial practices prohibit speculative activities and require investments to be grounded in real economic transactions as such, limits exposure to volatile market conditions and reduces the risk of significant financial losses due to market fluctuations (Beck, Demirgüç-Kunt, & Merrouche, 2013). The auditing framework is structured to enforce these principles by ensuring that all financial instruments and investment products comply with Islamic ethical guidelines, thereby promoting investments that are more stable and less susceptible to market risks (Archer & Karim, 2007). This approach not only mitigates market risk but also supports the development of a more stable and predictable financial system.

## CONCLUSION

To further advance Shariah auditing, several key areas need attention: Standardization: There is a pressing need for the development of comprehensive and universally accepted Shariah auditing standards that should cover all aspects of auditing, from financial statements to social responsibility. Training and Education: Enhancing the qualifications of Shariah auditors through specialized training in auditing and accounting is crucial. This includes not only training in traditional financial auditing but also in understanding the unique requirements of Shariah compliance. Empirical research: Encouraging empirical research is vital to address the current gaps in Shariah auditing practices. Research should focus on developing new methodologies and tools for Shariah audits, understanding the impact of different auditing approaches, and exploring ways to integrate ethical considerations more effectively into the audit process.

## AUTHORS' DECLARATION

### Authors' Contributions and Responsibilities

The authors jointly contributed to the conceptualization, design, and execution of this research. All authors collaborated in discussing the results, developing the proposed model for halal business strategy, and formulating practical recommendations.

### Competing Interests

The authors declare that there are no competing interests that could have influenced the conduct, analysis, or presentation of this research. This study was conducted independently without any financial, personal, or professional relationships that could be construed as a conflict of interest.

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