The Performance of Internal Shariah Auditor in Islamic Financial Institutions

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Abstract: Purpose – It is this study’s objective to examine the correlations between internal Shariah auditors’ independence, qualifications and performance in Islamic financial institutions (IFIs), conceptually.

Design/methodology/approach – This paper is theoretical in its approach; whereby it also undertakes an extensive literature review. From a general agency theory, an Islamic agency theory is articulated and applied to ascertain the attributes of internal Shariah auditor performance revolving around the concept of independence and qualifications.

Findings – Performance of internal Shariah auditing, as a mechanism of assuring Shariah compliance by IFIs varies directly with the degree of independence and qualifications enjoyed by internal Shariah auditors themselves. The study finds that in evaluating the freedom and qualifications of IFIs’ internal Shariah auditors, Islamic agency theory can potentially serve as the theoretical foundation in developing a multi-dimensional conceptual framework.

Research Limitations/implications – Evidence is drawn strictly from secondary sources.

Practical implications – To ensure that internal Shariah auditor is effectively performing, IFIs ought to improve the degree of independence and qualifications of their auditors.

Originality/value – The studies on the performance of internal and external Shariah auditor in conventional financial institutions have been extensively researched. However, research on the performance of IFIs’ internal Shariah audit is yet to be conducted extensively.

Keywords: Internal Shariah audit performance, independence, qualifications, IFIs

1. Introduction

When the Islamic financial institutions (IFIs) were introduced to Islamic principles, these IFIs have to undertake significant transformation, particularly in their business approaches whereby their audit method is affected(Karim, 2001). Therefore, the usual auditing goals have to be altered to accommodate the Islamic principles as the traditional audit method cannot fit in with the Islamic law values(Harahap, 2002). In view of the nascence of IFIs, there have been no mandatory regulated guides on auditing practices and accounting standards (Banaga, Tomkins, & Ray, 1994). The worldwide audit practices of IFIs are that in addition to the external auditors being responsible for financial auditing, every IFI has its own Shariah Supervisory Board (SSB) to ensure the compliance with Islamic laws. Failed companies such as WorldCom and Enron have shown the increasing need for the emphasis on in-house auditing. This consequently has encouraged the investments in internal audit and enhancement of their in-house Shariah auditors’ performance by the IFIs for the attainment of their organizational goals. These auditors’ main function to ensure that the IFIs’ system can effectively and strongly control the adherence to Islamic laws by having consistent periodic reviews (Rahman, 2011).

The significant role of in-house Shariah auditors in Islamic Financial Institutions, particularly of Islamic banks has resulted in many studies. Those IFIs that have in-house auditors who are effective are better than those that are without, particularly in detecting and preventing of problem areas as well as reduced frauds (Corama, 2006; Maria, 2012; Omar & Bakar, 2012). These auditors do only need to verify on corporate governance and provide in-house advice (Stewart & Subramaniam, 2010), they also have to conduct audit on the IFIs’ operation to verify that the organization complies with Islamic laws. Shariah audit is an emerging discourse topic consistent with the Islamic Financial Institutions’ rapid growth. It is imperative that those auditors be given the freedom while discharging their duties. Their role is unique. They are management appointed staff, but are simultaneously required to assess the management that appoints them. Consequently, this might lead to conflicting interest, as well as compromising their freedom while doing the audit. This situation puts a great pressure on these auditors as they may find that they are not entirely independent (Agarwal & Medury, 2014). When there is no independence, these auditors are only a component of the management, and they lost the capability to give new ideas through impartial review (Flesher & Zanzig, 2000). It is imperative that these auditors are independent in appearance and fact. Independence is “(1) real independence of the individual
practitioner in his performance of his work; (2) and second, the apparent independence of auditors as a professional group” (Mautz & Sharaf, 1961). The auditors’ independence is the foundation of their profession. This is because others might doubt the auditors’ opinions if there is no independence.

The tasks of Shariah audit is under the purview of the IB’s internal audit department where there must be an appearance of independence by these auditors so that outside parties will be convinced of their impartiality (Arens, 2008; Messier, 2002). These auditors’ work scope has widen where they are also responsible in ensuring corporate governance and giving in-house advices (Stewart & Subramaniam, 2010). As such, it is proposed that these auditors of IFIs must be independent (Kasim, Ibrahim, Hameed, & Sulaiman, 2009). As a new field, a few issues have to be addressed so as to create a strong Shariah audit in IFIs (Sundararajan & Errico, 2002). Among the matters that need to be addressed are the auditors’ independence, job scope, qualification, as well as audit standard. These issues need to be resolved as otherwise they will affect the industry negatively (Kasim & Sanusi, 2013). The scarcity of studies on this area needs to be addressed. The most applicable guideline that can be referred today by the Shariah auditors is the AAOIFI. Nonetheless, the comprehensiveness of this standard in assisting the auditors is completely another matter. The auditors must be satisfied and made sound appraisal on the compliance of the transactions and control with Islamic principles (Yahya & Mahzan, 2012).

Shariah auditor who has qualifications tends to demonstrate better independence, thus better auditing outcomes that would result in a successful Shariah auditing. Hence, in-house Shariah auditors are required to maintain their independence so that they will issue unbiased and reliable audit reports. However, it has become increasingly questionable whether the profession is able to maintain its independence not only in fact, but also in appearance (Ntsiful & Mwenechanya, 2011). This heightened concern expressed by many is owing to the reality that they are the IFIs’ staff, and they need to review and make reports on their organizations. This makes it an interesting area to study. In view of the above, the objective of the research is to examine the conceptual relationship between Shariah audit qualifications and independence of internal Shariah auditor. Very few research attention has been focused on this issue. The extent to these auditors’ independence and qualifications in influencing their performance still need to be clarified. This study aims to explore the status of independence and qualifications of internal Shariah auditors in IFIs and how these contextual factors affect their performance. The paper is about the Shariah audit’s definition, function and obligations, and independence. Next, is on the correlation between these auditors’ qualifications and independence together with underpinning theory, and ends with conclusion.

2. Literature review

Definition of Shariah Audit

In view that studies on internal Shariah audit are still in the early phase, certain basic matters and concepts are yet to be addressed. As an example, all fields of studies have to be appropriately defined prior to the exploration in other dimensions. Nonetheless, the definition of Shariah audit is yet to be unanimously agreed upon. In the most basic form, the definition of Shariah audit is the certification of auditors on the adherence to Islamic laws (Yahya and Mahzan, 2012). Nonetheless, it is not easily explained by this simple definition, and the study agrees that this definition may point at other directions. Meanwhile, the AAOIFI (no. 3) mentions that “the primary objective of the internal Shariah review (carried out by independent division or part of internal audit department) is to ensure that the management of an IFI discharge their responsibilities in relation to the implementation of the Shariah rules and principles as determined by the IFI’s SSB”. This statement clearly states that the goal of Shariah auditing is to ensure adherence to Shariah, and the audit department’s independent unit in the IFIs is responsible for this task. Haniffa (2010) had made a more thorough definition where Shariah audit is “a systematic process of objectively obtaining and evaluating evidence regarding assertions about religious and socioeconomic actions and events in order to ascertain the degree of correspondence between those assertions and those of the applicable financial reporting framework, including the criteria specified based on Shariah principles as recommended by the SSB and communicating the results to all interested parties”.

There is also a broader definition of Shariah audit through the inclusion of socioeconomic dimension besides the religious aspect. The operative meaning is that: “Shariah audit is the examination of an IFIs compliance with the Shariah, in all of its activities, particularly the financial statements and other operational components of the IFIs that are subjected to the risk of compliance including but not limited to products, technology supporting the operations, operational processes, the people involved in the key areas of risk, documentations and contracts, policies and procedures and other activities that require adherence to Shariah principles” (Haniffa, 2010; Sultan, 2007) as quoted in Yaacob, 2012; & Akram Laldin, 2009, as quoted in Mohiuddin, 2012). Even though the previous definitions lack the socioeconomic dimension, the dimensions of its operation such as procedures,
technology and processes are incorporated. Meanwhile, the definition of Shariah audit provided by Rahman (2008) is “the accumulation and evaluation of evidence to determine and report on the degree of correspondence between information and established criteria for Shariah compliance purposes”. Additionally, the definition given by Hameed (2011) is “a systematic process of objectively obtaining and evaluating evidence regarding assertions about socio-economic, religious and environmental actions and events in order to ascertain the degree of correspondence between those assertions and Shariah (Islamic Law), and communicating the results to user”.

Roles and Responsibilities of Shariah Auditor

It has been widely discussed that one of the main foundations of IFIs’ Shariah and corporate governance is Shariah audit. There has to be an assurance of adherence to all Shariah principles in the IFIs (Karim, 1990). These auditors who undertake the Shariah auditing role must have sufficient knowledge, experience, skills, and trainings, as well as being capable. Their reports are to be handed to the IFI’s SSB (Uddin, Ullah, & Hossain, 2013). The SSB will subsequently provide its opinions of only Shariah issues to the BOD, where the BOD will then make the ultimate decisions (IFSB, 2006; ISRA & Finance, 2013). It is the main goal of internal audit to guarantee that the IFI management carries out its duties in implementing Shariah principles as required by the SSB (AAOIFI, 2015). These auditors could also employ the services of those with expertise in Islamic finance for their audit tasks, provided that the goals are achieved (Yaacob, 2012). An outside party could also be appointed to conduct the audit (PwC, 2011).

Internal Shariah Audit Performance

The AAOIFI (2015) guideline of GSIFI No. 3 mentions that the in-house Shariah audit department must plan all its audit tasks. The documents involved in the planning must encompass of, but not restricted to, (1) gathering of background data on the activities that are to be examined, like branch, location, product/service, divisions and others; (2) developing audit’s goals and job scope; (3) procuring past years internal and external audits’ findings, SSB fatwas, directives, guidelines and related correspondence encompassing regulators and supervisory councils; (4) ascertaining the necessary resources needed for the audit tasks; (5) interacting with the relevant IFI staff on the audit; (6) conducting, suitably, an appraisal as to familiarize with the risks, activities, as well as control for the identification of areas that the auditors need to focus on, and soliciting the auditees’ feedbacks; (7) the auditing program is written (8) ascertaining the method and date of the audit outcome to be revealed; (9) procuring the relevant authority’s approval on the audit plan, including the IFI’s SSB.

The collecting, analyzing, interpreting and documenting of information have to be done by the internal Shariah auditors for the reinforcement of their audit findings. The data on every matter associated with the audit’s goals and scope must be gathered. The data must encompass of document inspection, analytical appraisals, queries, observations and discourse with top managers. The data must also be adequate, valid, appropriate and beneficial so that the audit’s results and proposals are solid. The auditors must also prepare a working paper and the Head of in-house Shariah audit shall appraise the said paper. This paper will support the audit’s results and proposals. It must be aptly done, finished, structured, assessed and maintained (AAOIFI, 2015). The head of in-house Shariah auditor would have a discussion on the conclusion and proposals with the management prior to the final report. Once the audit is completed, a written report is to be done quarterly and authorized by the Shariah audit head, directed to the BOD and a copy to the management and SSB. The report has to be impartial, comprehensible, timely and useful. It has to mention the audit’s purpose, boundary and findings, as well as the auditors’ views. It must also have proposals for possible enhancement, and changes, as well as recognition of acceptable achievement, where suitable.

The opinions of the auditees on the audit conclusion or proposals must be incorporated into the said audit report. For any disagreement on the interpretation of Shariah related issues between the in-house Shariah auditors and management, the SSB must be referred to for the final say. There must be a follow-up by the auditors to ensure that suitable actions are being carried out based on the audit report. Moreover, there must be follow-ups on other proposals made by the outside auditors, SSB and regulators. As such, the job description of the in-house Shariah auditors must stipulate that these auditors are to make their communication with the SSB and management directly and regularly. Theremust be also be complete accessibility to reports, staff, documents and others. This will subsequently leads to efficient and effective auditing role.

Internal Shariah Audit Independence

In audit, independent can be defined as being impartial while performing audit review, as well as in the furnishing and appraising of findings (Arens, 2008), where the management could fully rely on the audit results.
and proposals (Pickett, 2010). To be independent, there must be (i) freedom in thinking (ii) freedom in impression (MIA, 2006). Mautz and Sharaf (1961) stated that the meaning of actual independence or independence in-fact refers to the frame of mind of the auditors and their capability in maintaining acceptable perspective while planning the audit program. However, perceived independence or independence in appearance is the perception of the public towards the independence of the auditors. In-house Shariah auditors must be capable of demonstrating that their independence is not in being threaten, only then there will be a perception of independence. Being independent is vital to the auditors as it is the profession’s foundation (Mautz & Sharaf, 1961). Independence could be attained by the status of internal auditors in the organization, and their impartiality (Murtuza & Abdallah, 2007). All audit findings presented to the SSB may lead to independence issue in view that it is the SSB’s responsibility to decide and give views on Shariah transactions.

These auditors need to have a significant amount of independence so that the report users are confident. Also, the auditors need to have a direct reporting to the BOD in ensuring independence from the department they are auditing. Bank Negara Malaysia through it Shariah Governance Framework (2011) stipulates that internal audit department is responsible to conduct the Shariah auditing tasks. This shows that the in-house auditors’ job scope has widen where they need to conduct Shariah audit as to ensure the IFI’s adherence to Islamic principles (Shafii, Salleh, Hanefah, & Jusoff, 2013).

In addition to these auditors’ independence, their integrity is also being advocated by the IFIs’ stakeholders. Research related to the independence of internal audit has pinpointed on three variables that have significant contribution to the independence of the auditors: 1) the auditors’ responsibility is clearly defined, 2) the placement of the auditors in the structure of the organization, and 3) the hierarchy of reporting (Uddin et al., 2013). Kasim et al. (2009) stated that in reality, the IFIs’ Shariah audit relies heavily upon the in-house Shariah auditors or the management of the Shariah department. The separation of work is not being clearly defined, hence leading to self-evaluation. As such, despite the auditors being clearly aware on the expectation their independence, in reality they are unable to do so in view of certain inevitable situations. Hence, this results in the full capability of the auditors not being attained should the auditors are only partly and imperfectly independent. This is because its social goals (Umumah’s benefits) will not be attainable. A. Rahman (2008) mentioned that Shariah auditors are independent regardless whether they are practicing individually, or partners to accounting firms. Their experience, trainings and education make these independent auditors to be qualified to undertake audit tasks. To being independent means the auditors must be impartial in their auditing tasks, and appear unbiased to the users of their audit reports. Presently, there are no special trainings or any professional certification for internal Shariah auditors where they can effectively work and convey independent views.

**Internal Shariah Audit Qualifications**

According to the AAOIFI Auditing Standards (2015), “The auditor shall be knowledgeable about Islamic Shariah rules and principles. However, he/she would not possess the same level of knowledge as that of Shariah Supervisory Board members and thus the auditor shall not be expected to provide interpretation of these (Islamic) rules and principles. The Fatwas, rulings and guidance issued by the SSB form the basis on which the auditor considers whether the IFI has complied with the Islamic/Shariah rules and principles. The auditor shall also use this as a basis for concluding whether the financial statements of the IFI have been prepared in accordance with the Islamic Shariah rules and principles”. Until today the inadequate knowledge in accounting and Shariah has negatively affected the vital requirement for these auditors. There are situations where there are persons with Shariah knowledge but with no accounting background, and vice-versa (Yaacob, 2012).

A study by Flint (1988) mentioned that competency in auditing will require both skill and knowledge, which are products of experiences, trainings and education. To carry out a responsibility competently with reasonable diligence is in-line with a Hadith, “God loves those, when they do ask, they do it perfectly”. Nonetheless, to be technically proficient alone is inadequate in undertaking the tasks and attaining the expected outcome within the Islamic principle (Kasim, 2009). The investments in Shariah education, particularly auditing and accounting are important in enhancing those related to Shariah auditing particularly, and Islamic financial institutions generally (A. R. A. Rahman, 2011b; Sulaiman, 2011). Past studies have concentrated on inadequately qualified personnel for the attainment of effective internal audit. Studies by Ali, Gloeck, Ali, Ahmi, and Sahdan (2007) and Ahmad et al. (2009) analyzed the Malaysian government sector’s internal audit and discovered that there are inadequate qualified workers, i.e. knowledge, trainings and experiences where this situation has a negative impact on the function of internal auditors. The study proposed that training is the important factor in enhancing the internal auditors’ performance.

**Proposition**
3. Theoretical Framework

In accordance to the discussion above, the theoretical framework is presented below:

**Underpinning Theory**

The definition put forth by the Islamic agency theory on contract is that, it is when one or more individuals (principal) appoint another individual (agent) to represent them in certain tasks including the delegation of authority to make decisions (Jensen & Meckling, 1976). Principal refers to the manager, or owner of a business who entrusts and transfers his/her capital or responsibility to an agent. Meanwhile, the agent refers to the manager/staff of the business who supervises business activities on behalf of the principal/owner. (Jensen & Meckling, 1976) who are the advocates of agency theory states that the definition of agency relationship is the contractual association between the shareholders (principals) and managers (agents) where the agents are bestowed certain power to conduct transactions for the principals. In IBs, agency issues are more acute. This is because the investors of traditional FIs have a degree of return assurance; but in IBs the profit or possible loss, as well as risks are shared by both the IBs and investors (Siddiqui, 2001). An individual may assign his/her company to an agent where the agent acts on his/her behalf. Nonetheless, agency contract is regulated, whereby the key terms in the agency contract are similar to the common Islamic agreements, with the exception that the scope and nature of the power are bounded by some limitations. The agent is being given an authority by the muwakeel (principal). A principal who is a minor, or of unsound mind is not allowed to be part to any agency agreements. Nonetheless, an agent may be appointed by a minor to perform activities that are beneficial to the minor, but not in activities entailing the minor (Shamsuddin & Ismail, 2013)

This proposed research focuses on two variables: Shariah auditors’ qualifications as well as internal Shariah auditor independence. The theoretical framework is constructed in accordance to agency theory in which there will be agency cost incurred by the principals for observation of their agents’ actions. The association between agent and principal will result in monitoring cost by the principal; while the agent will incur bonding cost where it is to ensure that the principal’s wealth is properly managed (Adams, 1994). As agents, the internal Shariah auditors must undertake their tasks professionally where academic certification, audit experience, excellent performance as well as practices of benchmarking are required. All these factors will facilitate their expression of views on the IFI’s financial report and Shariah adherence issues. Also, these factors will also provide them the other necessary skills to undertake their tasks effectively. There will be an increase in the confidence towards the auditors’ competence by the BOD and audit committee when these auditors have such excellent background, in addition to the existing training programs. From this dimension, the agency theory gives the foundation in explaining the independence and responsibility issues of the in-house Shariah auditors (Adams, 1994).

4. Conclusion

This study conceptually examines the association between internal auditors’ qualification, independence and their performance in Islamic Financial Institutions. This study’s limitations are: the independent variables are limited to only qualification and independence, and it is a conceptual analysis into the IBs’ audit practices. Nonetheless, this study makes a contribution to the Shariah auditing literature by presenting independence of IFIs’ internal Shariah auditors together with their qualification on audit performance. This study also proposes that more studies are to be conducted on the IFIs’ internal Shariah audit. Therefore, future studies could examine
other mediators or moderators that could impact or strengthen the correlation between Shariah auditors’ qualification, independence and their performance.

5. References