SHARIAH AUDIT EFFECTIVENESS IN ISLAMIC BANKS: A CONCEPTUAL FRAMEWORK

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Abstract: The global Islamic finance industry recorded a total value of USD 1.88 trillion (RM8.0652 trillion) representing 17 per cent average annual growth, and it is anticipated that Islamic finance will be able to reach USD6.5 trillion by the year 2020. Accordingly, this situation increases the awareness and concern of the community on the obligation to implement Islamic commercial jurisprudence (muamalat) as a necessity to seek the blessings from Allah SWT. However, in the eagerness of Islamic banks in providing those products and services to customers, Islamic banks sometimes have overlooked certain matters that ultimately affect the Shariah-compliant nature. Thus, Shariah audit performed by internal auditor as one of the lines of defense in Islamic banking operation has been established to ensure that the overall processes and activities in Islamic banks do not contravene Shariah Principle. In fact, the existence of the internal auditor function must be effective enough to ensure the control mechanism. Many scholars argued that the Shariah audit effectiveness (SAE) is very important for the sustainability of the Islamic banks. Therefore, this paper attempts to discuss the factors such as competence, independence, ISA activities and management support that may contribute to internal Shariah audit (ISA) effectiveness in Islamic banks. The findings of this paper will have few important implications for Shariah auditors, Shariah Supervisory Board, bank management, policy makers, regulators, shareholders, creditors, customers, suppliers and the Muslim population at large.

Keywords: Shariah audit effectiveness, Shariah compliance, Islamic banking industry

1.0 Introduction

Islamic finance has evolved for the past 40 years to cater the need of its users regardless of their faith and religiosity. Unlike its conventional counterpart, Islamic finance relies on its users trust and confidence with regards to the compliance towards Shariah principle. In order to achieve users, trust and confidence, it is necessary for the Islamic banks to strengthen its monitoring role and Shariah compliance accordingly. One of the tools or lines of defense as stipulated by Shariah Governance Framework 2011 is the existence of the internal Shariah auditor (Bank Negara Malaysia, 2011).
Auditing is not a new concept in the Islamic tradition. During the early part of the Islamic age, Muslims scholars’ thoughts regarding accounting and auditing were recorded in the Islamic literature based on the Islamic perspective (Al-Quran and As-Sunnah). Their recorded are a testimony to the Islamic scholars’ devotion to numerous calls by Allah SWT in the Holy Quran, emphasizing the importance of recording one’s deeds and actions.

In fact, every deed and action performed by human beings is continuously recorded by Allah’s (SWT) angels to the finest details, which will be accounted for in the Hereafter. Moreover, Allah’s (SWT) also reminds all human beings to record all their transactions truthfully as evident in many verses in the Holy Quran, underscoring the process of recording actions and deeds in all transactions, including business transactions. For instance, such imperative is emphasized by the verses as follows:

“We shall set up justice scales for the Day of Judgment, not a soul will be dealt unjustly in the least. And if there be (no more than) the weight of mustard seed, we will bring it (to account) and enough are We to take account” (Al-Quran Chapter 21, verse 47) and

“O you who believe! When you deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing and let a scribe write down faithfully as between the parties” (Al-Quran Chapter 2, verse 282).

Based on the above verses, Allah SWT surely will audit every single thing that has been done by the creatures rigorously in the Day of Judgment. In addition, it is vital for the human being to record the business transactions in relation to future obligation, so that they could recall their debts and commitments that owe to the others accordingly (Ali, 1997).

The failures of giant corporations such as Enron and WorldCom lead to emphasis on the importance of effective internal auditors. Similarly, in Islamic banks, there is a need for internal Shariah auditor to strengthen the internal control and to ensure Shariah compliance in the company. This requires Islamic banks to capitalise in internal auditing and improve the effectiveness of internal Shariah auditor that eventually assist in achieving the organisation objective (Abdul Wahab & Abdul Rahman, 2011).

On the contrary, if the Islamic banks fail to monitor the internal control and strengthen the lines of defense in the organisation, the probability of Shariah non-compliance activities or events to occur is very high (Lahsasna, 2014). The existence of the Shariah non-compliance activities can damage the Islamic banks’ reputation and may reduce the confidence of depositors, shareholders, customers, and other stakeholders towards the institutions.
Dusuki, 2011; Shafii, Salleh, & Shahwan, 2010). Hence, any income earned from non-compliant transactions should be channelled to charitable organisations and should not be recorded as normal income from operation.

Taking into account the rapid growth of the industry and the severe consequences for the non Shariah compliance as stipulated in the Islamic Financial Services Act (IFSA, 2013), it is necessary for the Islamic banks to have a proper ‘check and balance’ mechanism in the form of Shariah auditing which fits the objectives as well as the missions of its formation, the ‘Maqasid as-Shariah’ or the objective of Shariah (Yaacob & Donglah, 2012). Undeniably, this initiative is very important for the sustainability of Islamic finance. Thus, the evaluation of the role, mechanism and effectiveness of ISA in the Islamic banks as endeavored in this study could highly contribute towards the literature.

Furthermore, it would be essential for auditors to aim for greater legitimacy in the Islamic spirit to help apprehend the Maqasid Shariah (the objective of Shariah). If Islamic banks fail to fulfil Islamic values, there would be unbearable moral costs for auditors that will be much greater than economic losses (Othman & Ameer, 2015). This is due the fact that the internal Shariah auditors carry Islamic values with their appearance.

Therefore, this paper attempts to discuss factors such as competence, independence, ISA activities and management support that may contribute to ISA effectiveness in Islamic banks. The organisation of this paper is as follows. First, Shariah audit will be defined briefly. Then, factors such as competence, independence, ISA activities and management support will be explained in the next section. Finally, the conclusion is drawn accordingly.

2.0 Shariah Audit and Effectiveness

According to Abdul Rahman (2008), Shariah audit can be defined as the accumulation and evaluation of evidence to determine and report on the degree of correspondence between information and established criteria for Shariah compliance purposes. Meanwhile, Hameed, (2008) proposes a definition of Shariah audit as 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 users.

From the other point of view, Bank Negara Malaysia (2011) defines Shariah audit as the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI’s business operations, with the main objective of ensuring a sound and effective internal control system for Shariah compliance.
Recently, Bank Negara Malaysia issued Exposure Draft on Shariah Governance on 9th November 2017 by proposing a new definition of Shariah audit. Under this new development, Shariah audit is defined as an independent assessment on the quality and effectiveness of the IFI’s internal control, risk management systems, governance processes as well as the overall compliance of the IFI’s operations, business, affairs and activities with Shariah (Bank Negara Malaysia, 2017).

Many scholars argued that the effectiveness is paramount for the sustainability of Islamic banks (Khalid, Haron, & Masron, 2017, 2018; Khalid, Haron, Sarea, & Masron, 2018; Shamsher & Muhamad Sori, 2016). The Institute of Internal Auditors (2010) defines effectiveness in general as a degree including quality to which established objectives are achieved. Internal auditing should establish performance metrics and related measurement criterion appropriate to its organisation to measure the degree (including quality) of achievement of objectives for which the internal audit activity is established. Meanwhile, Bank Negara Malaysia (2011) defines effectiveness as an objective to make sure a sound and effective internal control system to ascertain the Shariah compliance.

### 3.0 Factors Contributing to ISA Effectiveness

#### 3.1 Competence

Abdul Rahman (2008) asserted that Shariah audit should be performed by a competent independent person. The competence of the auditor performing the audit is compromised if he or she is biased in the accumulation of evidences. There has been increasing professional education agendas in accounting and auditing to ensure that they keep up-to-date of the cutting-edge thoughts and procedures in auditing and accounting (Mansouri, Pirayesh, Assistant, & Salehi, 2009).

Accounting and Auditing for Islamic Financial Institutions (AAOIFI), (2015) under Governance Standards No. 3 Para 12 specifies that, internal Shariah auditors should possess the disciplines, knowledge and skills crucial to the performance of ISAs. Competency or expertise in Shariah principles in general, and Fiqh al-Muamalat in particular, is needed in performing ISAs.

Both Shariah and accounting knowledge are still lacking in the profession of Shariah auditor since 1970s (Ahmed, 2017). This argument has been supported by Rashid, Hamid, Subhi, & Sidek, (2017) who claimed that a big challenge facing the auditor is their lack of knowledge and expertise on matters related to Shariah. In line with this issue, Khalid, Haron, & Masron, (2017) suggested that there is a critical need for proper trainings and courses on Shariah concepts since most of the bankers are from conventional background. Thus, competence in the Shariah concepts seems is very important in ensuring the effectiveness of ISA.
3.2 Independence

According to Abdul Rahman (2008), Islamic audit should be conducted by not only a competent, but also an independent person. Though absolute independence is difficult to achieve, Shariah auditors must struggle to preserve a high level of independence to sustain the confidence of internal as well as external users on their financial reports. In the case of ISA, they theoretically report to top management directly, thus keeping the ISA independent of the operating unit that they audit.

Shariah audit must be carried out by the internal auditors and reviewed by SSB (Bank Negara Malaysia, 2011). However, Kasim & Mohd Sanusi (2013) argued that the perceived independence has been infringed because they are full-time personnel of the Islamic banks. Since there is no clear line of separation of duties that is central in the practice of good governance, the Islamic banks will have to reconsider the needs for clear separation of duties.

According to Rashid, Hamid, Subhi, & Sidek (2017), regular independent Shariah audit in Islamic banks are compulsory as people today are characterized by people who believe everything and audit nothing to a people that believe nothing and audit everything. In other words, regular independent Shariah audit in Islamic banks is perceived to play a fundamental part in order to attain Maqasid Shariah.

3.3 ISA activities

ISA are required to perform their work according to the auditing standards by planning their audit work appropriately, implementing their work well and also communicating the results of their audit work to the suitable parties (Khalid et.al, 2017). The adequacy of audit’s scope of work and the standard with which the audits are planned, performed and reported are illustrations of effective IA (Al-Twaijry, Brierley, & Gwilliam, 2003).

The conventional financial audit is inadequate to fulfill the desires of the stakeholders of Islamic banks (Haniffa, 2010). This situation occurs due to the fact that International Standards on Auditing (ISAs) that does not consider the Shariah aspects in their audit performance. Unlike their conventional counterparts, the ultimate purpose of Shariah audit is for the maslahah of the ummah (public interest) (Kasim, Sanusi, Mutamimah, & Handoyo, 2013), rather than profit-oriented. Accordingly, the scope of Shariah audit should be much wider as compared to their conventional counterpart (Khalid et al., 2017).

Thus, according to Yaacob & Donglah (2012), the scope of Shariah audit should be broader, covering “social behavior” and organisational performance including their relationship with all the stakeholders. Therefore, ISA
activities is an important determinant in the Islamic banks since it will reflect the efficiency and effectiveness of ISA.

3.4 Management Support

Management support is crucial to the acceptance and appreciation of the internal audit within an organisation (Dellai, 2016). The management support could be in the form of allocating sufficient human and resources to IA. One of the examples highlighted by Institute of Internal Auditors (IIA) is good monitoring that depends on professional management in assuring precise internal audit performance (Salehi, 2016).

Shariah Governance Framework (2011) highlighted the importance of management support in allocating sufficient resources and talented manpower in order that Shariah audit could be performed efficiently and effectively (Bank Negara Malaysia, 2011). Islamic banks should ensure that a substantial amount of allocated budget is for trainings and development. Proper training allocation is important due to the fact that Shariah auditors need to be knowledgeable in Shariah related knowledge, such as *Fiqh Muamalat*. Hence, having support from top management in the form of adequate resources is important so that audit department could perform their duties and obligations (Salehi, 2016).

The management commitment to execute the internal audit recommendations is also important in achieving audit effectiveness (Mihret & Yismaw, 2007). The existence of management support also permits resources being used by management for execution of internal control to ensure that Islamic banks comply with the Shariah precepts (Badara & Saidin, 2014; Shafii et al., 2010). Hence, it is anticipated that management support is an important factor in assuring the effectiveness of ISA in Islamic banks.

Figure 1: Conceptual framework for Shariah audit effectiveness

Factors perceived that contribute to Shariah Audit Effectiveness

| Competence | Independence | ISA Activities | Management Support |

**Conceptual framework for Shariah audit effectiveness**
4.0 Conclusion

Despite the importance of ISA effectiveness as a corporate governance mechanism, there is scarce literature, which addresses the issue of ISA effectiveness. Therefore, it is pertinent to comprehensively investigate key factors perceived to contribute to the effectiveness of ISA. More importantly, the effectiveness of ISA will be able to mitigate the recurrence of Shariah non-compliance in the Islamic banks. This study argues that competence of Shariah auditors, independence of Shariah auditors, ISA activities and management support are among the factors that contribute to the effectiveness of ISA in Islamic banks. Future research may consider other potential variables such as religiosity or Islamic ethics since this dimension has been given special attention by scholars in enhancing performance, satisfaction as well as effectiveness (Wening & Choerudin, 2015).

References


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