The Role of Internal Auditing in Ensuring Governance in Islamic Financial Institutions (IFIs)¹

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Abstract

Auditing in the Islamic framework has wider a scope than the current practice of auditing due to the distinct worldviews and concepts (Hamid et.al., 1993; Haneef, 1997; Abdul Rahman, 2008) embedded in Islamic regulation known as ‘shariah’. In fact, in the light of Islamic teaching, the role of auditor would assimilate some different approach and objectives especially in upholding shariah principles (Khan, 1985). The two main issues relate to the shariah audit framework and the factors affecting their judgment of internal auditors while conducting audit of Islamic financial institutions. Shariah audit might be simply be defined as an audit attestation for shariah compliance. However, little is known on what should be the practical model defining issues such as scope, extent, audit reporting and qualification as well as factors affecting the judgment of the auditors. This can only be done through conducting audit on their operations based whether it is comply with shariah principles. This study attempts to draw the general framework that may be adopted for auditing Islamic financial institutions. In addition, it seeks to identify the factors that influence the auditor’s judgment during shariah audit that will ensure the credibility of Islamic banking activities in terms of fulfilling shariah principles and meeting the objectives of the IFI. Research data for this study will be obtained from primary source which come from individuals and focus groups (internal auditors from IFIs). The study will employ field experimental research.

Keywords: auditing, Islamic banking, judgment decision making

INTRODUCTION

The emergence of Islamic financial institutions (IFIs) has created a new phenomenon within the global finance arena and particularly in the development of Islamic economics and finance. Considerable attention has been developed in the area of Islamic economics and Islamic finance. Though the efforts are still needed in formulating the idea of Islamic economics and Islamic finance in the areas of accounting and auditing due to the development of Islamic financial institutions triggers significant changes and demand from the public. Recent researches have shown an emerging concern with the interaction of business activity and Islam (Gambling & Karim, 1986; Abdel – Magid, 1981; Alam, 1991; Hamid et.al., 1993; Mirza & Baydoun, 1999). Islam has recognized business activities can be part of ibadah (worship and obedience to Allah) if they are performed in accordance with the commands of Allah and the Islamic code of conduct. This can be interpreted in several of Quranic verses such as 2:30; 14:32-33 and 31:20). Therefore, Islam does not separated business or worldly activities as such.

¹ Research related to this paper is still in progress. Please do not quote without permission of the authors
However, research and study especially in the area of accounting and auditing still in demand as it need to capture the effects on the compliance of Islamic beliefs on the operations of Islamic financial institutions within the Islamic framework or shariah principles. In particular, the incompatibility of many Western values and norms with Islamic practices requires explanations (Hamid et al., 1993; Mirza & Baydoun, 1999). Auditing in Islamic framework would have a wider scope than traditional auditing. In contemporary practice, the auditor is directly liable only to his client’s who are the owner of the business being audited. He is not guided by religious principles, the quality of managerial decisions too are not his concerns. Therefore, the auditor is just responsible to give his opinion whether company’s financial statement being prepared in accordance with accounting and auditing standards. In light of Islamic teaching, the role of auditor would assimilate some different approach and objective i.e. upholding shariah principles.

Shariah audit might be simply defined as an audit attestation for shariah compliance. However, a lot of issues still not resolved and discovered. Among the issues are; how comprehensively we should define shariah audit?; What is the scope of shariah audit?; What makes shariah audit framework different from the conventional auditing framework?; What types of audit planning should we establish in order to uphold shariah principles?; Who are qualified to perform the task?; How the auditor’s judgment affects their decision while performing audit on Islamic banking products?: These are among the questions that are yet to be resolved with regards to the shariah audit. As a results, the practices of shariah audit as well as the understanding of shariah audit, principles and factors that influence auditors while they perform judgment is little known and heterogeneous.

Study conducted by Khan (1985) probably can be assumed as initial discussions on auditing in Islamic framework as he discussed on the role of the auditor in an Islamic economy and interpreted shariah audit as religious audit and this interpretation was been used by Karim (1990). Meanwhile, Alwi (2007) defined shariah audit in a broader perspective by looking to other area such as organization structures, operational processes, the people involved, documentation, policies and procedures and other activities that requires adherence to shariah principles. Currently, Islamic auditing practices been conducted through one committee established by the IFIs. The committee is known as shariah supervisory board (SSB) or shariah committee.

The main role of this committee is to ensure that the IFIs activities are adherence with shariah principles. In Malaysia as example, the establishment of shariah committee is compulsory for every IFIs. It was been regulated by Bank Negara Malaysia on 1st April 2005. However, the current practices might not reveal the best to be practices. Hence, given the complex issues of shariah audit, examination and understanding of shariah audit and judgment affecting auditor’s judgment while performing shariah audit is perceived to be vital. Besar et.al (2009) emphasized on the importance of shariah audit as they highlighted that there is a need for shariah committee to have specified scope and well documented auditing methods during shariah review which clearly define shariah consideration to be taken in the execution of shariah review which is by having proper working papers, guidelines, plans and checklist to cover the scope of work provided for the shariah review.

Despite the extensiveness of theoretical and empirical research on the judgment decision making in the West on the factors affecting the auditor’s judgment, past research investigating auditor’s judgment while performing shariah audit or conduct their audit process on the Islamic banking products remain emergent. Judgment decision making research in auditing requires researcher to use a psychological lens to understand, evaluate and improve judgment, decisions, or choices in an auditing setting (Nelson, Tan and Trotman, 2005). Therefore, this study attempts to fill this gap by providing insight into through discussion due to the different nature of concepts and frameworks, the shariah audit requires different approach that can affects the judgment decision making done by the auditors. The audit process entails judgments about the amount and type evidence to collect, the extent to which such evidence is credible, and the actions that should be taken in response to the evidence that has been collected and evaluated. (Ashton and Ashton, 1995). Hence, shariah audit for
the Islamic financial institution requires auditors to express their judgment whether the banking activities and products comply with the *shariah* principles. Therefore, research on the factors and approach of auditors to perform judgment is important and pertinent to ponder and investigate.

**OBJECTIVES OF THE STUDY / RESEARCH QUESTIONS / SIGNIFICANCE OF THE STUDY**

This study is mainly motivated by lack of research on the *shariah* auditing and factors affecting judgment decision making while auditors performing *shariah* auditing in Islamic financial institutions. Indeed, ongoing and current discussion on *shariah* audit have yet to explore on the understanding of operators and community on the role, function, perception and factors affecting auditor’s judgment on *shariah* audit in the real practice. In fact, there was very limited study conducted on the comparisons of concept between *shariah* audit and conventional audit. This is importance in determination on which of conventional auditing concept that can be adopted by *shariah* audit and how far the different of the concepts can affect the way of auditors performing their judgment.

In addition, it is interesting to note that so far no specific standard on *shariah* audit has been promulgated as compared to conventional auditing. Currently, AAOIFI has established and Governance standard on *shariah* review which can be considered as the most relevant guideline available for *shariah* practice. However, whether the standard is able to cater to the practice of *shariah* audit in comprehensive manner is still another question to ponder. The *shariah* auditor should satisfy himself and elicit accurate judgment that the transactions he examined during his audit comply with Islamic *shariah* rules and principles. Yet again, regarding the issues of judgment and decision making among auditor, there was no study has been conducted to measure the approach and factors affecting judgment among the auditors.

Therefore, the primary objectives of the study are twofold; firstly, the study aim to discuss and delineate the different concepts of audit from Western perspectives and Islamic perspectives. Due to the distinctive concepts and features of audit in Islamic perspective, second objective of the study is intend to investigate factors affecting auditor’s judgment on their decision making while performing audit process by looking to the factors that have been established by some authors, which were derived from Western perspectives and Islamic perspectives. To accomplish the above objectives, hence four research questions are formulated as follows:

1. What should be the definition of *shariah* audit? This question will explore the concept of auditing from western perspectives in comparisons with the Islamic perspectives in terms of objective, principles and practices.
2. What is the scope of *shariah* audit? This question encompasses the investigation on the business areas to be audited under *shariah* audit, the extent of *shariah* audit, timing of *shariah* audit, the importance and content of *shariah* audit report. In addition, this question also will try to investigate whether current audit practices is compatible with the *shariah* audit which will be based on Islamic principles.
3. What are the factors affecting on the auditor’s judgment decision evaluation criteria while they conducting audit judgment process? The study will then contrast the judgment evaluation criteria developed from Western perspective and Islamic perspective.
4. How the auditors conduct their judgment decision making? The study will investigate on how and how well auditors make judgment and decisions and the impact of the judgment from Islamic point of views i.e. in terms of *shariah* compliance. In addition, this question will investigate whether the auditor’s judgment and decision making is reliable, consistent and compliance with *shariah* principles.
This study is significant in various ways. Through exploring the factors affecting auditor on judgment decision making process, it will investigate theoretically and empirically the factors affecting the auditors while they perform audit process on the financial statement of Islamic financial institution. Therefore, by adding audit function, the users of the financial statements have reasonable assurance that the financial statement does not contain material statement and omission and provide valuable assurance for operating information, information system reliability and entity’s internal control. Meanwhile, for Islamic financial institution, the most important criteria should be emphasized by the auditor while they performing auditing are about compliance with Islamic principles or shariah principles. Therefore this study attempts to fill the gap in current auditing research, judgment decision making research and Islamic banking research by providing insight into dual perspectives which are from Western and Islamic perspectives. The study also hopes to assist standards setters and regulatory bodies in setting up the relevant standards and audit programme with regards to shariah audit. This can be done by having clear understanding on the concept, principles, objectives and approach on shariah audit.

CONCLUSION

This research intended to contribute towards a better understanding of the behavior of internal auditors in a unique environment of Islamic banking which requires different philosophical concept by investigating factors affecting their judgment while they need to perform shariah auditing or Islamic auditing. The usage of some judgmental theories in this new context will further enhance the credibility of the model and enriched both the knowledge of Islamic auditing and studies in judgment decision making.

REFERENCES


