

Independence and effectiveness in internal Shariah audit with insights drawn from Islamic agency theory

Effectiveness
in internal
Shariah audit

Azam Abdelhakeem Khalid

*Department of Accounting and Finance, Universiti Pendidikan Sultan Idris,
Tanjung Malim, Malaysia, and*

Adel M. Sarea

Accounting and Finance, Ahlia University, Manama, Bahrain

Received 25 February 2020
Revised 18 May 2020
13 October 2020
Accepted 20 October 2020

Abstract

Purpose – This paper aims to examine bases of effectiveness in internal Shariah auditing undertaken in Islamic financial institutions (IFIs).

Design/methodology/approach – This paper is theoretical in approach taking, as its starting-point, an extensive literature review. From a general agency theory, an Islamic agency theory is articulated and then applied to ascertain attributes of internal Shariah audit effectiveness revolving around the concept of independence.

Findings – Effective internal Shariah auditing, as a mechanism of assuring Shariah compliance by IFIs, varies directly with the degree of independence enjoyed by internal Shariah auditors themselves. The research propounds that an articulated Islamic agency theory holds potential to serve as a theoretical foundation to build a multi-dimensional conceptual framework based on independence utile for evaluating internal Shariah audit effectiveness.

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

Practical implications – To assure effectiveness of internal Shariah auditing, IFIs ought to increase the level of independence of internal Shariah auditors.

Originality/value – Internal Shariah audit effectiveness in IFIs has not been extensively studied in comparison with both studies of external Shariah audit effectiveness in IFIs and internal audit effectiveness undertaken by conventional financial institutions. This research fills that gap.

Keywords Effectiveness, Islamic agency theory, IFIs, Independence, Internal Shariah audit

Paper type Conceptual paper

1. Introduction

The issue of the effectiveness of internal audit has received increasing attention in the literature in recent times. Internal auditors assist management in ensuring that there is a proper internal control system in place and that the commercial operations are carried out efficiently, economically and legally (Haron *et al.*, 2004). Internal Shariah auditing contributes to Islamic financial institutions (IFIs) through the generation of financial reports tracking the performance of IFIs in terms of compliance with Shariah principles. The high esteem attached to the Internal *Shariah* Audit Department of an Islamic bank derives from its conduct of the internal Shariah audit regarded as the key element in the application of accounting systems in an internal evaluation and control capacity *vis-à-vis* compliance and



risk management. The Internal Shariah Audit Department evaluates all Islamic banking transactions with a view to advising operational units in IFIs how to achieve their objectives through managing risks and improving internal control.

To ensure the achievement of organization objectives in IFIs, effective internal Shariah auditing necessitates not only investment by IFIs in internal auditing resources but also enhancement by IFIs of the independence of internal Shariah auditors (Rahman, 2011). In gauging internal Shariah audit effectiveness across multiple dimensions level of independence, reporting level, direct contact, conflict of interest, interference, unrestricted access, appointment and removal this research explores, through application of Islamic agency theory, the extent to which internal Shariah auditing effectiveness contributes to IFI performance. In line with this, the purpose of this paper seeks to discern linkage effectiveness of internal Shariah audit with Insights drawn from Islamic Agency Theory.

The contribution of this paper is to fill the gap in the existing literature. For instance, due to the absence in the existing literature with regard to the Shariah Audit with insights drawn from Islamic Agency Theory, the contribution of this study is the use of the agency theory to enhance the practices of the independence and effectiveness in internal Shariah auditing undertaken in IFIs. The structure of this paper as follows: Section 1 gives the introduction; Section 2 presents the literature review; Section 3 provides the conceptual framework; and Section 4 concludes the paper with a discussion..

2. Literature review

2.1 Auditing from the Islamic point view

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 (Khalid *et al.*, 2019). **Holy 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. (Quran, 84:7-9)

And indeed, [appointed] over you are keepers, Noble and recording. They know whatever you do. (Quran, 82:10-12)

Sunnah:

Prophet Mohammad (p.b.u.h) says: when he has been about IHSAN: “.then tell me about IHSAN: He said: it is to worship Allah as though you are seeing Him, and while you see Him not you truly, He sees you[. . .]”

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 Accounting and Auditing of Islamic Financial Institution (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. The predominant practices in auditing have promoted over centuries to serve the needs of the capitalist

economy. Khan (1985), states that auditing in IFIs has assimilated some of these Western techniques that suit the institutional and socioeconomic infrastructure of Islamic society. The objective of conventional financial reports is to provide information to users, which it is useful for making and evaluating decisions about the allocation of scarce resources in the capitalist economy. IFIs have similar objectives for financial reporting under the Shariah requirements, but those who deal Shariah compliant business entities such as IFIs or stakeholders in such entities (such as managers, auditors, account holders, creditors) are concerned with the business entities' compliance with Shariah requirements in their financial and other transactions. In an Islamic economy, the Rab ulmal (depositor) who provide capital on the basis of profit-loss sharing needs an extended assurance that the profit (or loss) declared by the IFI manager is true and correct. To make sure that business transactions are measured, recorded and reported in accordance with Islamic rules and principles, accounting principles compatible with Maqasid Al-Shariah (Islamic law) is a key distinguishing lineaments of interest-free banking compared to conventional banking (Karim, 1990).

Conventional auditing and financial reporting complies with Anglo-American laws and is not guided by any religious law or codes. Conventional auditor is not accountable to stakeholders, as in IFIs, in relation to the funds lent to the borrowers and how these are utilized by the borrowers. The auditors also have no social obligations to comment on the investments or transactions undertaken by the business which might cause the depletion of non-renewable resources or generate socioeconomic externalities (Khan, 1985). On the other hand, the auditor's role does not extend to the examination of management practices and their impact on society. The auditing standards and financial reporting premised on Anglo-American accounting thoughts and practices inadequately service the needs of IFIs because these do not accommodate Shariah requirements which form the basis of all Islamic transactions. This creates the need of to have accounting and auditing standards of Shariah compliant business entities (AAOIFI, 2019). Hence, the work of auditors is fundamentally and conceptually different from conventional auditors. such, the scope of auditing in an Islamic framework is much larger as compared to the scope of traditional (conventional) auditing, as it expands from the traditional concept of attest and authority to report on various social and economic aspects of the business organization (Khan, 1985).

Inasmuch as they are supposed to be operating under the Islamic worldview, IFIs, serving the needs of Islamic community whose focus and priorities are different from other worldviews they are expected to serve (binti Kasim and Sulaiman, 2009), need accounting and auditing systems at variance with conventional financial institutions (Ibrahim, 2000 and Khan, 2001). Islamic Shariah auditing provides a mechanism to generate advice, especially with proposed new Islamic financial products, and to monitor performance so that the IFIs operate strictly on Islamic principles. The need for a comprehensive Shariah audit, conducted in accordance with guidelines published by Accounting and Auditing Organization for IFIs (AAOIFI), stems from the requirement of Shariah compliance. It is incumbent on internal Shariah auditors, should they find any violation of the Islamic principles in the operation of organization, to report such infractions to the *Shariah* supervisory board (SSB), whose main duty is to certify the adherence of the banks to Shariah principles. All IFIs have an SSB in-house.

Currently, auditing practice of IFIs in various countries is governed by laws and regulations in force in their respective local jurisdictions with some having fully and others having partially adopted AAOIFI standards. AAOIFI standards of Shariah audit provide guidelines considered to be, by scholars and practioners alike, the most comprehensive available for navigating Shariah audit practice, be it internal *or* external. Shariah audits,

handled by internal audit department of Islamic banks, span an examination of contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements reports. In applying accurate judgment in the course of the full span of this examination, the internal Shariah auditor should satisfy himself through the audit process of the complete conformity of the IFI to Islamic Shariah rules and principles (Yahya and Mahzan, 2012). In this process, continuous periodical assessment serves as the backbone for a sound and effective internal control system for gauging Shariah compliance in IFIs (Rahman, 2011). Apart from serving as a compliance agent, however, the internal Shariah auditor serves to ensure corporate governance as well as to provide a well-spring of internal consultancy (Stewart and Subramaniam, 2010).

2.2 Internal Shariah audit effectiveness

Many scholars argued that the effectiveness is paramount for the sustainability of Islamic banks (Khalid *et al.*, 2017, 2018; Khalid *et al.*, 2018; Shamsheer and 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 (2010) defines effectiveness as an objective to make sure a sound and effective internal control system to ascertain the Shariah compliance. Internal Shariah audit effectiveness has been defined in different ways by various organizations and scholars in the field of Islamic banking. According to Institute of internal audit (IIA) (2010), effectiveness can be defined as degree including quality to which established objectives are achieved.

According to AAOIFI (2019) effectiveness is the performance of internal Shariah audit work such as ability to plan, implementation, document information, Shariah audit findings, recommendations, numbers of repeated reports, follow up and evaluation of extent of Shariah compliance with Islamic Shariah rules and principles, Fatwas, guidelines and instructions by the IFI's SSB (AAOIFI, 2019). Badara and Saidin (2013), in their research highlighted a few definitions of the effectiveness term. It means that internal audit effectiveness can be defined as the degree to which established objectives are achieved. Most of the researchers agree that a program can be seen as effective if its outcome goes along with its objective (Ahmad *et al.*, 2009; Ussahawanitchakit, 2012). A distillation of the above definitions suggests that internal Shariah audit effectiveness can best be identified with the ability of internal Shariah auditors to achieve established objectives within IFIs.

Previous studies in Shariah audit have investigated varied facets: the needs and challenges of Shariah audit (Rahman, 2008), perceptions of academicians and practitioners towards Shariah audit (Mulyany, 2008), professionalization of Shariah auditing (Najeeb and Ibrahim, 2014), conceptualizing the duties and rules of Shariah auditors (Othman and Ameer, 2015) and articulation of an auditing framework for Shariah compliance (Shafii and Hanefah, 2013). Additionally, several studies on Shariah audit practices in IFIs have focused on the current scope of, competencies involved in, practices associated with and framework Shariah auditing (binti Kasim and Sulaiman, 2009; Nik Suliman, 2012; Yahya and Mahzan, 2012). Relative to external audit effectiveness in IFIs and to internal audit effectiveness in conventional banks, however, internal Shariah audit effectiveness has been less extensively studied. Among others, Ahmad (2009), Badara and Saidin (2014), Endaya and Hanefah (2013) and Getie Mihret and Wondim Yismaw (2007) have conducted noteworthy research germane to internal audit effectiveness. In an attempt to address this lacuna in the literature, while simultaneously building upon extant topical research, however much exiguous, this

study investigates the relationship between independence and effectiveness of internal Shariah audit in IFIs. From the author's review of literature, no extant study examines auditing independence, through the prism of Islamic agency theory, as a driver of internal Shariah auditing effectiveness in IFIs.

Nonetheless, the current study is not *sui generis*. [Ahmed and Chapra \(2002\)](#) isolated factors that undercutting the effectiveness of internal audit in Malaysian public sector: lack of training and support from management, lack of employees, and negative perception of management towards the recommended solutions given by internal auditors. Beside the above, the level of training, education, experience as well as professional qualifications of the internal auditors influence the effectiveness of internal audit ([Al-Twajiry et al., 2003](#)). Interpersonal skills, internal auditor's commitment and support from audit committee and BOD, audit performance and integrity, audit department efficiency, auditing competencies, internal auditor's knowledge on company's business operation and industry and auditor independence are found to be important attributes contributing towards internal audit function effectiveness ([Nasibah et al., 2009](#)). In addition, the study found that expectations of stakeholders the board of directors, CEO, and operating management towards the performance of an organization has a direct bearing on perceptions of internal audit effectiveness. [Feizizadeh \(2012\)](#). Moreover, effective internal Shariah auditor professionals exemplify an ability to align internal Shariah audit with particular Islamic banks operations in ways resonating with the needs and expectations of SSBs. In assessing Shariah compliance, which, in turn, serves to contribute positively to the Ummah (society) at large ([ISRA, 2013](#)), effective internal Shariah auditing transcends detecting of fraud within their organizations. Effective internal Shariah auditors assist corporate stakeholders in creating value through improving performance in the IFI by meeting a spectrum of objectives espoused by the latter ([Al-Twajiry et al., 2003](#); [Arena and Azzone, 2009](#); [Mihret et al., 2010](#); [Getie Mihret and Wondim Yismaw, 2007](#)).

2.3 Independence in Shariah audit

As an emerging discipline, Shariah auditing systemic theory and practice for IFIs revolve around several issues in urgent need of resolution ([Sundararajan and Errico, 2002](#)). One such issue is ascertaining the ideal level of internal Shariah auditor independence ([Kasim and Sanusi, 2013](#)). Independence in auditing engenders objectivity in the performance of audits with a minimum of bias associated with the issuance and evaluation of auditing reports ([Arens et al., 2008](#)) such that management can attribute full confidence to audit findings and recommendations ([Pickett, 2010](#)). Independence entails both independence of mind and independence in appearance. It is essential for an auditor to demonstrate independence in terms of both attributes. In this vein, [Mautz and Sharaf \(1961\)](#) delineated independence to be "(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 and Sharaf \(1961\)](#) distinguish between actual and perceived independence. Actual independence reflects the auditors' state of mind and is directly linked to his/her ability to maintain freedom in the planning and execution of any audit. Whereas, perceived independence refers to the perceptions of the auditor's independence on the part of corporate stakeholders and publics. Undue restrictions on internal Shariah auditor independence negatively impinge on internal Shariah audit effectiveness such that independence is widely reputed as being the cornerstone of the profession ([Mautz and Sharaf, 1961](#)). To be independent, the Shariah auditor should be without bias with respect to the client under audit and should appear impartial to those relying on the results of the audit [Rahman \(2008\)](#).

The degree of independence mirrors the organizational status imparted to internal auditing and impinges on the level of objectivity of internal auditors ([Murtuza and Abdallah, 2007](#)). A

high level of independence on the part of Shariah auditors serves to keep the confidence of users relying on their reports. To facilitate independence from the operating unit they audit, it behoves the internal Shariah auditor to report directly to the board of directors (BOD) and to the audit and governance committee (AGC).

[BNM Shariah Governance Policy Document \(2019\)](#) defines Shariah audit as a function that provides 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.

The Shariah audit function, at minimum, must:

- establish an audit methodology to assess the risk profile and vulnerabilities of each auditable area;
- generate an audit plan for the assignments to be performed;
- establish clear documented audit programs that provide guidance to the internal auditors in gathering information, auditing procedures and audit assessment; and
- communicate results to the board and Shariah committee through an audit report, detailing the audit findings and recommendations for rectification measures, as well as the auditee's responses and action plans.

The independence of the internal Shariah auditor serves as a key attribute in the effective discharge of his duties in professional practice. The internal Shariah auditor effectuates a delicate balancing inasmuch as, while appointed by the management, the internal Shariah auditor is charged with reviewing the conduct of the same management. Potential conflicts of interest, to which the internal Shariah auditor may be subject, serves to erode his independence while conducting his work. Such tensions risk undermining internal Shariah audit effectiveness as undue influence exerted on him by management undermines objectivity of auditing results ([Agarwal and Medury, 2014](#)). Without substantial independence, the internal auditor simply becomes assimilated into the management team with a consequent loss of ability to offer a fresh perspective through objective evaluation ([Flesher and Zanzig, 2000](#)).

Inasmuch as without it the auditor's opinion is suspect, independence is the cornerstone of the auditing profession. The literature on internal audit independence pinpoints three factors that significantly contribute to the degree of auditor independence:

- (1) clear delineation of the auditor's responsibility;
- (2) the position of the internal auditor, in terms of degree of prestige, in the institution's organizational hierarchy; and
- (3) the reporting structure ([Uddin et al., 2013](#)).

In practice, the management of the Shariah unit relies on internal Shariah auditors to carry out Shariah audit objectively in IFIs. Where no clear lines of demarcation have been set with respect to the ambit of the Shariah auditor, self-review may occur ([binti Kasim and Sulaiman, 2009](#)) with the result that full potential of an audit cannot be realized. Undue restrictions on the independence of internal auditors frustrate the social purpose (benefit to the Ummah) of Shariah auditing.

3. Regulatory requirements of Shariah auditing

3.1 Objective and principles of Shariah audit

This Auditing Standard for Islamic Financial Institutions (ASIFI) is intended to set guidelines and provide guidance on the purpose and general principles governing the audit

of financial statements prepared by a financial institution that conducts business in compliance with the rules and principles of Islamic Shariah. The aim of the audit of the financial statements is to allow the auditor to express an opinion as to whether, in all material respects, the financial statements are prepared in compliance with the Shariah Rules and Principles, the accounting standards of the IFIs Accounting and Auditing Organization (AAOIFI) and the applicable national accounting standards and practices. “Give a real and reasonable view” is the term used to express the opinion of the auditor. Although the opinion of the auditor increases the integrity of the financial statements, it is not possible for the user to conclude that the opinion is a guarantee as to the potential viability of the financial institution, or as to the efficiency or effectiveness with which the management has carried out the financial institution’s standards.

3.2 The auditor’s report

The aim of this ASIFI is to set standards and provide guidance on the form and content of the auditor’s report issued as a result of an audit carried out by an independent auditor of a financial institution’s financial statements that conducts business in accordance with the principles of Islamic Shariah. The auditor should review and analyse the conclusions taken from the audit evidence gathered as the basis for the expression of an opinion on the financial statements. Much of the guidance given can be applied to the auditor’s reports on financial information other than financial statements. This analysis and examination includes considering whether the financial statements were prepared in compliance with the accounting standards of the Accounting and Auditing Organization for IFIs.

3.3 Terms of audit engagement

The aim of this ASIFI is to set criteria and provide guidance on the appointment of an auditor to audit the financial statements of a financial institution that conducts business in accordance with the Islamic Shariah Rules and Principles. The key points are as follows:

- agree on the terms of the engagement with the IFI (the client); and
- the auditor’s response to the client’s request to change the terms of the undertaking to one that offers a lower degree of assurance.

The auditor and the client should agree on the terms of the undertaking. The negotiated terms should be reported in an audit engagement letter or other acceptable form of contract. This ASIFI is intended to assist the auditor in the preparation of engagement letters concerning audits of the financial statements of IFIs. The norm shall also extend to similar facilities. Where other services such as tax, accounting or management advisory services are to be rendered, different letters may be sufficient to make a clear distinction between statutory audit and other services. In certain nations, the aims and nature of the audit and the auditor’s responsibilities.

3.4 Testing for compliance with Shariah rules and principles

The aim of this ASIFI is to lay down guidelines and provide guidance on checking for compliance with the Shariah Rules and Principles by an external auditor in connection with the audit of the financial statements of a financial institution that conducts business in accordance with the Islamic Shariah Rules and Principles. For the purposes of this ASIFI, the term “auditor” shall be used only to refer to the external auditor. The term “auditor” shall not refer to any internal audit role which may be affiliated with the IFI. When testing the compliance of Shariah, the auditor shall obtain sufficient appropriate audit evidence to

provide the auditor with reasonable assurance that the IFI (IFI) has complied with the Islamic Shariah Rules and Principles. As stated in ASIFI (1), fair assurance is the idea of the accumulation of audit facts required for the auditor to conclude that there are no material errors in the financial statements taken as a whole. Reasonable assurance applies to the entire audit process. ASIFI (1) also notes that “Reasonable assurance also ensures that the auditor is confident that the transactions he reviewed during his audit comply with the Islamic Shariah Rules and Principles as well”.

3.5 Auditor responsibility to consider fraud and error in an audit of financial statements

The aim of this ASIFI is to provide guidance on the responsibility of the auditor when considering the possibility of fraud and error in the audit of the financial statements of the IFI. The primary responsibility for the prevention and identification of fraud and error lies with those responsible for corporate governance and management. However, when preparing and executing audit procedures and reviewing the findings of such audits, the auditor shall consider the possibility of material errors arising from fraud and error. The norm shall set out the following:

- instructions on the character of the fraud and error and the restriction of the auditor’s duty in relation to the fraud and error;
- define the minimum procedures to be applied by the auditor in the event of an indication, review and discussion of any fraud or mistake in the financial statements of the IFI; and
- advice to auditors on management statements about fraud and error in the IFI.

The standard shall be read in accordance with all ASIFIs issued by the Organization for the AAOIFI. This standard complements the guidelines provided by the International Federation of Accountants on the consideration of fraud and error by complying with clear additional IFI standards.

4. Islamic agency theory

The term Wakalah or Wikalah is a noun derived from the word Wakala which has several meanings, including performing a task on behalf of others. Technically, Wakalah refers to a contract, in which a muwakkil (principal) authorises a party as his Wakil (agent) to perform task on his behalf. According to [AAOIFI \(2019\)](#) Wakalah is “the act of one party delegating the other to act on its behalf in what can be a subject matter of delegation”.

In the Quran, Allah (SWT) says, “Now send one of you with this money to the town; let him find out which is the best food and bring some to you” (18:19). He (AWT) also mentions, “commission two arbiters, one (representative) from his family and one (representative) from hers” (4:35). In another verse, Allah (SWT) say, “Alms are for the poor and the needy and those employed to administer the fund[. . .]” (9:60). In general, these verses specify several types of agencies including appointing an agent to buy food, an agent to be arbiter, an agent to collect for charity (Zakah). Regarding the proofs from the Sunnah, there are several hadith indicating the legality of the agency contract, such as the authentic hadith that the profit (SAW) delegated “Urwah to purchase a sheep on his behalf” (al-Bukhari, hadith no. 3642). Muslim scholars have come to a consensus on the permissibility of the Wakalah contract. This due to the people’s dire need of assistance in accomplishing certain tasks that they are incapable of doing on their own.

The Islamic agency theory inculcates partners to practice respect, gratitude, patience, tolerance and also to believe not only in the economic reward/outcome as in conventional

agency theory but also in spiritual rewards (blessings from Allah). Lying, shirking, conceit and jealousy, as contrary to Islamic teaching, must be avoided by each party vested with spiritual knowledge. Islam recognizes the knowledge process of each individual; seeking knowledge is a continuous process in Islam. Furthermore, the spreading of knowledge has been encouraged by the Prophet Mohammed (p.b.u.h). "Allah illuminates a man who hears hadith from me preserves it carefully and passes it on to other". Therefore, it is crucial to implement Islamic training emphasizing the importance of knowledge, individual development and ethically oriented practices in organizations. Islamic agency theory uses the Quran and Hadith to determine the features and framework of the economic relationship practices in IFIs (Safieddine, 2009).

Several researchers have explored Islamic economics as a field in relation to the principle-agent relationship (Ismail and Tohirin, 2010; Pratomo and Ismail, 2006; Sarker, 1999; Umer and Habib, 2002). Inasmuch as life must be guided by Tawhid, this study can use Tawhid epistemology as guiding principles applied to Islamic agency theory. Unity, Khalifah, (vicegerent), Ihsan are the principal elements underlying agency theory in Islam. Agency problems can be reduced through the concept of unity effectuating organizational cooperation and participation absent from conventional agency theory (Shamsuddin and Ismail, 2013). Our social life or business activities cannot be undertaken without instilling the concept of unity. Thus, internal Shariah auditors participating in an Islamic-oriented agency relationship have to apply Islamic Shariah rules and principles promulgated by AAOIFI in accordance with Fatwas and guidelines issued by SSB.

Concepts of Khalifah (vicegerent) and Ihsan bear positively on relationships governed by Islamic agency theory. Reporting on Ihsan: socioeconomic values of the Islamic economy include Ihsan. Ihsan in turn, is a cluster of various value such as Amana. In an Islamic economy, the adoption and promotion of Ihsan are one of the requirements of the Shariah. In line with the concept of Khilafah, accountability places a greater emphasis on the duties than on rights because if duties are fulfilled by everyone, self-interest is automatically held within bounds and the rights of all are undoubtedly safeguarded (Chapra and Chapra, 1992).

Information asymmetries exacerbate the agency problem, where the principal cannot access, in its entirety, the information of the agent; however, no such information asymmetry obtains when both parties are engaged in a relationship with Allah. An agent (wakil) knows that they have an obligation to provide for the best interest of the principals (muwakkel). Both parties believed that Allah has the perfect knowledge and for all their actions they will be accountable in the hereafter; therefore, each of their actions and decisions has to in sync with obligations faithfully undertaken as codified in their agency contract (Shamsuddin and Ismail, 2013).

4.1 Independence and effectiveness of internal Shariah audit in light of Islamic agency theory

Agency theory presupposes a contract under which one or more persons [principal(s)] engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent (Jensen and Meckling, 1976). The agency problem is more intense in the case of IFIs inasmuch as, from the perspective of investors, conventional banks, barring credit default, have a set level of certainty in their returns, manifested in fixed or floating interest rates. In Islamic banks, on the other hand, return cannot be predetermined according to a base-line rate given profit/loss inhering in the shared risks between IFIs and their customers (Siddiqui, 2001). According to Safieddine (2009), the agency problem in IFIs, transcending separation of ownership and control, extends to the separation of cash flow and control in a way not encountered by conventional banks.

From the very beginning, Islam emphasizes the importance of relationships. Any relationship in this world, especially for Muslims, should begin with the relationship to Allah s.w.t. As mentioned in the Quran “Behold a host gathered against you, so beware of them- whereupon this only increases their faith, so that they answered, God is enough for us; and how excellent a guardian is He”. AlQuran 3:173. Relying on faith through building a concrete relationship with Allah s.w.t, serves as a point of departure for good relationships with other humans and other living things in this world. In Islamic economics, the relationship with others may exist between e.g. the capital provider (rabbul mal) and entrepreneur (mudarib), among capital providers or partners, buyers and seller, agent (wakeel) and principal (muwakkel), contractor (wakif) and beneficiaries (muawikif), pledge (marhun) and assets owner (murtahin). Generally, this relationship creates a principal-agent relationship.

5. Conceptual framework

Basing on the discussion in the preceding sections and in line with the explanation of the theory with regard to the conceptual relationship between independence and effectiveness of internal Shariah audit, the following conceptual framework is posited (Figures 1 and 2).

5.1 Conceptual framework “proposed Islamic agency theory”

Internal Shariah auditors with independence are better able to leverage their unique mix of knowledge competencies, capabilities and skill derived from extensive professional practice in auditing in such a way that enhances their efficiency and effectiveness (Getie Mihret and Wondim Yismaw, 2007). Audit independence enables experienced internal Shariah auditors, well versed in identification and mitigation of unique risks stemming from Shariah non-compliance, to generate utile Shariah audit results as well as practical recommendation. Additionally, the discipline, knowledge and skills essential to the effectiveness of internal Shariah audit derived from proficiency in Islamic Shariah rules and principles in general and Fiqh al-muamalat in particular cannot be fully brought to bear in the absence of substantial independence (AAOIFI, 2019). Internal Shariah auditors with high levels of independence are empowered to generate effective decision-making on an efficient basis characterized by speed as well as accuracy and practicality in a variety of contexts. Accordingly, expertise manifested by internal Shariah auditors spur growth in IFIs benefitting from clear insights imparted by internal Shariah auditors about how to manage transactions and processes efficiently and effectively evincing superior quality. The concept of Islamic agency theory can enhance Shariah audit exercise with other internal and external factors, internal factors such as SSB, board of directors and management support, whereas external factors such as Shariah auditing institutions, Islamic banking law, external Shariah auditor and external auditor. In addition, competency, scope of Shariah audit and structure are the other aspects that will enhance internal Shariah audit effectiveness with the support from Islamic agency theory.

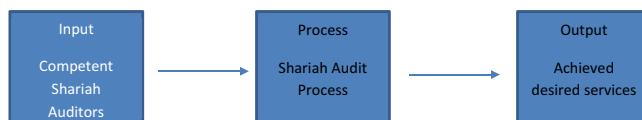
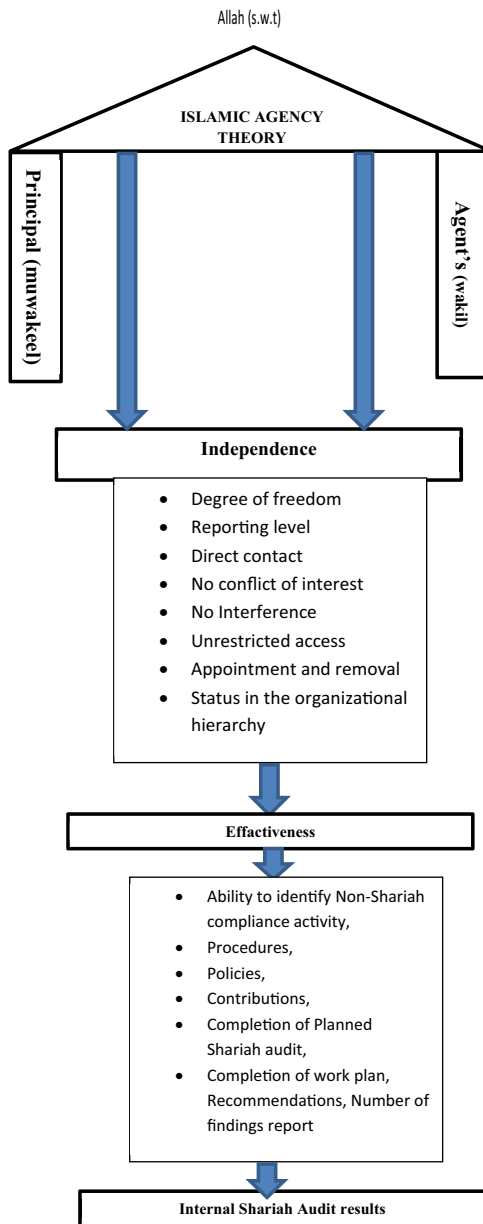


Figure 1.
Shariah audit process

Source: Hameed and Mulyany (2007)



Effectiveness
in internal
Shariah audit

Figure 2.
Proposed framework

Islamic agency theory informs that internal Shariah auditors maximize effectiveness when endowed with the full spectrum of independence across multiple dimensions (degrees of freedom, reporting level, direct contact, conflict of interest, interference, unrestricted access, appointment and removal and status in the organizational hierarchy) by minimizing the

injection of bias in auditing performance (Arens *et al.*, 2008) such that management can place full reliance on audit findings and recommendations (Pickett, 2010). In other words, internal Shariah auditors manifesting independence of mind/in fact or actual independence and their ability to maintain a proper attitude in the planning of the audit program and independence in appearance/perceived independence or publics or others perceptions of the auditor's independence (Mautz and Sharaf, 1961) are more likely to achieve positive organizational outcomes for IFIs than internal Shariah auditors whose independence is unduly constrained (Murtuza and Abdallah, 2007).

6. Discussion and conclusion

6.1 Research implication

This paper provides various implications to practitioners and academicians. Moreover, this contribution serves as recommendations to IFIs and a contribution to the body of knowledge. The internal Shariah audit effectiveness and its independence are very important to IFIs. However, the implications of the study can be classified into theoretical and practical implications. In furtherance to the above, the study has contributed to Islamic agency theory in examining the relationship of independence (reporting level, direct contact, no conflict of interest, unrestricted access, appointments and removal and status in organizational hierarchy) and effectiveness of internal Shariah audit. Practical implications of this study, the regulators need to provide a detailed framework for internal Shariah audit to covers the main requirements for effective Shariah governance. Through the prism of Islamic agency theory, this research explores the conceptual relationships between independence and effectiveness of internal Shariah audit in IFIs. Given that the agency problem in IFIs exceeds that in conventional financial institutions, internal auditors in the former require greater independence that in the latter to obtain an equivalent level of performance. Existing literature links effectiveness of internal Shariah auditing to the level of independence of internal Shariah auditors performing audits in IFIs. From this analytical basis, the current research provides perspective on the effectiveness of internal Shariah auditing in IFIs through a multidimensional articulation of independence spanning: degrees of freedom, reporting level, direct contact, conflict of interest, interference, unrestricted access, appointment and removal and status in the organizational hierarchy. The research explores the conceptual relationships between independence and effectiveness of internal Shariah audit in IFIs based on Islamic agency theory. Existing literature review shows limitation of studies on effectiveness of internal Shariah audit related to independence of internal Shariah audit in IFIs. This research in a way is an effort towards adding more literature on the subject under study and contributing towards a better understanding on the effectiveness of internal Shariah audit in IFIs which requires different set of human capital. This research propounds that Islamic agency theory could be productively used as a basis for building an analytical framework able to gauge the impact of multi-dimensional attributes of independence on effectiveness of internal Shariah auditing. In general, higher levels of effectiveness are associated with greater levels of independence at least to a perceived point of diminishing returns to scale. As this research focuses solely on theoretical constructs, the proposed conceptual framework needs to be verified empirically. Therefore, this study recommended that empirical research be conducted to treat the relationship between the factors of independence and effectiveness of internal Shariah audit based on real data from IFIs.

References

- AAOIFI (2019), *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, AAOIFI, Bahrain.
- Agarwal, G.K. and Medury, Y. (2014), "Internal auditor as accounting fraud buster", *IUP Journal of Accounting Research and Audit Practices*, Vol. 13 No. 1.
- Ahmad, N., Othman, R., Othman, R. and Jusoff, K. (2009), "The effectiveness of internal audit in Malaysian public sector", *Journal of Modern Accounting and Auditing*, Vol. 5 No. 9, p. 53.
- Ahmed, H. and Chapra, M.U. (2002), "Corporate governance in Islamic financial institution", (Occasional Paper) (No. 93), The Islamic Research and Teaching Institute (IRTI).
- Al-Twajjry, A.A., Brierley, J.A. and Gwilliam, D.R. (2003), "The development of internal audit in Saudi Arabia: an institutional theory perspective", *Critical Perspectives on Accounting*, Vol. 14 No. 5, pp. 507-531.
- Arena, M. and Azzone, G. (2009), "Identifying organizational drivers of internal audit effectiveness", *International Journal of Auditing*, Vol. 13 No. 1, pp. 43-60.
- Arens, A.A., Loebbecke, J.K., Elder, R.J. and Beasley, M.S. and American Institute of Certified Public Accountants (2008), *Auditing: An Integrated Approach*, Prentice Hall, Upper Saddle River, NJ, Vol. 8.
- Badara, M.A.S. and Saidin, S.Z. (2013), "Antecedents of internal audit effectiveness: a moderating effect of effective audit committee at local government level in Nigeria", *International Journal of Finance and Accounting*, Vol. 2 No. 2, pp. 82-88.
- Badara, M.A.S. and Saidin, S.Z. (2014), "Empirical evidence of antecedents of internal audit effectiveness from Nigerian perspective", *Middle-East Journal of Scientific Research*, Vol. 19 No. 4, pp. 460-469.
- Bank Negara Malaysia (2010), *Shariah Governance Framework for Islamic Financial Institutions*, Bank Negara Malaysia, Kuala Lumpur.
- Binti Kasim, N. and Sulaiman, M. (2009), "Shariah auditing in Islamic financial institutions: exploring the gap between the 'desired' and the 'actual'", *Global Economy and Finance Journal*, Vol. 2 No. 2, pp. 127-137.
- BNM Shariah Governance Policy Document (2019), Bank Negara Malaysia (BNM), Kuala Lumpur: BNM, available at: www.bnm.gov.my/index.php?ch=57&hx0026;pg=140&ac=835&bb=file (accessed 25 September 2019).
- Chapra, M.U. and Chapra, M.U. (1992), *Islam and the Economic Challenge*, Islamic foundation Leicester.
- Endaya, K.A. and Hanefah, M.M. (2013), "Internal audit effectiveness: an approach proposition to develop the theoretical framework", *Research Journal of Finance and Accounting*, Vol. 4 No. 10, pp. 92-102.
- Feizizadeh, A. (2012), "Strengthening internal audit effectiveness", *Indian Journal of Science and Technology*, Vol. 5 No. 5, pp. 2777-2778.
- Flesher, D.L. and Zanzig, J.S. (2000), "Management accountants express a desire for change in the functioning of internal auditing", *Managerial Auditing Journal*, Vol. 15 No. 7, pp. 331-337.
- Getie Mihret, D. and Wondim Yismaw, A. (2007), "Internal audit effectiveness: an Ethiopian public sector case study", *Managerial Auditing Journal*, Vol. 22 No. 5, pp. 470-484.
- Hameed, S. and Mulyany, R. (2007), "Shariah audit for Islamic financial institutions (IFIs): perceptions of accounting academicians, audit practitioners and Shariah scholars", *IJUM Accounting Conference, Gombak*.
- Haron, H., Chambers, A., Ramsi, R. and Ismail, I. (2004), "The reliance of external auditors on internal auditors", *Managerial Auditing Journal*, Vol. 19 No. 9, pp. 1148-1159.

-
- Ibrahim, S.H.M. (2000), "Nurtured by 'kufr': the Western philosophical assumptions underlying conventional (Anglo-American) accounting", *International Journal of Islamic Financial Services*, Vol. 2 No. 2, pp. 19-38.
- IIA (2010), "Definition of internal auditing", *Institute of Internal Auditors*, available at: www.theiia.org/guidance/standards-and-guidance/ippf/definition-of-internal-auditing/ (accessed October, 2010).
- ISRA (2013), *Islamic Financial System, Principles and Operations International Shariah Research Academy for Islamic Finance (ISRA)*, ISRA, Kuala Lumpur.
- Jensen, M.C. and Meckling, W.H. (1976), "Theory of the firm: managerial behavior, agency costs and ownership structure", *Journal of Financial Economics*, Vol. 3 No. 4, pp. 305-360.
- Kasim, N. and Sanusi, Z.M. (2013), "Emerging issues for auditing in Islamic financial institutions: empirical evidence from Malaysia", *IOSR Journal of Business and Management*, Vol. 8 No. 5, pp. 10-17.
- Khalid, A.A., Halim, H.A. and Sarea, A.M. (2019), "Exploring undergraduate students' awareness of internal Shariah auditing in Malaysia", *Humanities and Social Sciences Reviews*, Vol. 7 No. 1, pp. 461-468.
- Khalid, A.A., Haron, H.H. and Masron, T.A. (2017), "Relationship between internal Shariah audit characteristics and its effectiveness", *Humanomics*, Vol. 33 No. 2.
- Khalid, A.A., Haron, H. and Masron, T.A. (2018), "Competency and effectiveness of internal Shariah audit in Islamic financial institutions", *Journal of Islamic Accounting and Business Research*, Vol. 9 No. 2.
- Khan, M.A. (1985), "Auditing in Islamic framework", *Hamdard Islamicus*, Vol. 8 No. 4, pp. 65-76.
- Khan, M.A. (2001), "Role of supreme audit institutions in shaping the Islamic economy in the 21st century", *IJUM Journal of Economics and Management*, Vol. 9 No. 1, pp. 77-100.
- Mautz, R.K. and Sharaf, H.A. (1961), "The philosophy of auditing: American accounting association", Monograph No. 6, American Accounting Association, Sarasota, FL.
- Mihret, D.G., James, K. and Mula, J.M. (2010), "Antecedents and organisational performance implications of internal audit effectiveness", *Pacific Accounting Review*.
- Mulyany, R. (2008), "Shariah audit for Islamic financial institutions: perception of accounting academicians, audit practitioners, and Shariah scholars. (Master of Science in Accounting)", International Islamic University Malaysia, Malaysia.
- Murtuza, A. and Abdallah, W. (2007), "Islamic Muhtasib and American CPAs: a comparative study of institutions meant to protect public interest", *Journal of Accounting, Business and Management*, Vol. 14.
- Najeeb, S.F. and Ibrahim, S.H.M. (2014), "Professionalizing the role of Shari'ah auditors: how Malaysia can generate economic benefits", *Pacific-Basin Finance Journal*, Vol. 28, pp. 91-109.
- Othman, R. and Ameer, R. (2015), "Conceptualizing the duties and roles of auditors in Islamic financial institutions: what makes them different?", *Humanomics*, Vol. 31 No. 2, pp. 201-213.
- Pickett, K.S. (2010), *The Internal Auditing Handbook*, J. Wiley.
- Pratomo, W.A. and Ismail, A.G. (2006), *Islamic Bank Performance and Capital Structure*, MPRA.
- Rahman (2011), "Enhancing the integrity of Islamic financial institutions in Malaysia: the case for the Shariah audit framework", *ISRA International Journal of Islamic Finance*, Vol. 3 No. 1, pp. 135-147.
- Rahman, A. (2008), "Shari'ah audit for Islamic financial services: the needs and challenges", Paper presented at the ISRA Islamic Finance Seminar, Mandarin Hotel, Kuala Lumpur.
- Safieddine, A. (2009), "Islamic financial institutions and corporate governance: new insights for agency theory", *Corporate Governance: An International Review*, Vol. 17 No. 2, pp. 142-158.

- Sarker, M.A.A. (1999), "Islamic business contracts, agency problem and the theory of the Islamic firm", *International Journal of Islamic Financial Services*, Vol. 1 No. 2, pp. 12-28.
- Shafii, Z.S.S. and Hanefah, H.J.K. (2013), *Human Capital Development in Shariah Audit*, USIM.
- Shamsheer, M. and Muhamad Sori, Z. (2016), "Effectiveness of Shariah committees in the Malaysian Islamic financial institutions: the practical perspective", *Middle East Insights Islamic Finance Special*, Vol. 2, pp. 1-8.
- Shamsuddin, Z. and Ismail, A.G. (2013), "Agency theory in explaining Islamic financial contracts", *Middle East Journal of Scientific Research*, Vol. 15 No. 4, pp. 530-545.
- Siddiqui, S.H. (2001), "Islamic banking: true modes of financing", *New Horizon*, Vol. 109 No. 2, pp. 15-20.
- Stewart, J. and Subramaniam, N. (2010), "Internal audit independence and objectivity: emerging research opportunities", *Managerial Auditing Journal*, Vol. 25 No. 4, pp. 328-360.
- Sundararajan, V. and Errico, L. (2002), *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*, Vol. 2, International Monetary Fund.
- Tohirin, A. (2010), "Islamic law and finance", *Humanomics*, Vol. 26 No. 3, pp. 178-199.
- Uddin, M.H., Ullah, M.H. and Hossain, M.M. (2013), "An overview on the basics of Islamic audit", *European Journal of Business and Management*, Vol. 5 No. 28, pp. 9-17.
- Umer, C.M. and Habib, B. (2002), "Corporate governance in Islamic financial institutions", *Occasional Paper No. 6*, Jeddah, IRTI/IDB.
- Ussahawanitchakit, P. (2012), "Audit independence of tax auditors in Thailand: roles of ethical orientation, professional responsibility, stakeholder pressure, and audit experience", *Journal of the Academy of Business and Economics*, Vol. 12 No. 1.
- Yahya, Y. and Mahzan, N.M. (2012), "The role of internal auditing in ensuring governance in Islamic financial institution (IFI)", *International Conference on Business and Economic Research, 12-13 March 2012, Bandung*.

Further reading

- Rahman, A.R.A. (2010), "Shariah audit for Islamic financial services: the needs and challenges", *The Journal of Muamalat and Islamic Finance Research*, pp. 133-146.
- Rahman, A.R.A. and Rahim, A. (2011), "Enhancing the integrity of Islamic financial institutions in Malaysia: the case for the shariah audit framework", *ISRA International Journal of Islamic Finance*, Vol. 3 No. 1, pp. 135-147.

Corresponding author

Azam Abdelhakeem Khalid can be contacted at: azamabdelhakeem@gmail.com

For instructions on how to order reprints of this article, please visit our website:

www.emeraldgrouppublishing.com/licensing/reprints.htm

Or contact us for further details: permissions@emeraldinsight.com