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## Determinants of the Effectiveness of Internal Shariah Audit: Evidence from Islamic Banks in Bangladesh

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### Abstract

The concept of Shariah-based internal audit has received increasing attention from researchers in recent times especially since Islamic financial institutions have been developing in several Asian countries like Bangladesh. To avoid financial irregularities and to maintain Shariah-based financial transactions, an effective Shariah-based internal audit system is extremely important for Islamic financial institutions such as Islamic banks. Hence, the objective of this study is to determine the factors that influence the effectiveness of the Shariah-based audit system. Study data has been gathered from Shariah auditors, members of the Shariah board and audit committee of six private Islamic banks in Dhaka, Bangladesh. A total of 210 survey questionnaires were sent and finally 136 responses were retained, indicating a final sample size of  $n=136$ , with a survey feedback rate of 65%. The study adopted a quantitative measure and collected only primary data, followed by convenience sampling. SPSS has been used to run necessary statistical interpretation. Results reveal that auditor's work autonomy, level of competency, and work performance significantly impact the Shariah-based internal audit effectiveness. The study findings can be adopted as guidelines to improve the overall effectiveness of the Shariah-based internal audit system in Islamic financial institutions.

**Keywords:** Shariah Audit, Islamic Banks, Bangladesh, Shariah Board, Effectiveness of Shariah Audit

**JEL Classification Code:** G20, G21, G28

### 1. Introduction

Bangladesh is one of the world's fastest-growing economies and *has been* clocking rapid *GDP* growth rates since 2004 (Akhter et al., 2020a; Akter et al., 2020; Hossain et al., 2019; Rahaman et al., 2020). This type of growth is vital to becoming a developing country. In 2018, Bangladesh fulfilled all three eligibility criteria for graduation from the UN's Least Developed Countries (LDC) list for the first time. This begins the graduation process for Bangladesh, which could receive official developing country status by

2024 (Akhter et al., 2020b). In this development process, the financial sector especially banks have played a critical part in accelerating this economic growth (Islam et al., 2020). At the same time, the Islamic banking system has been gaining popularity among Muslim countries such as Bangladesh, as the majority of the population belongs to the Islam religion. Consequently, Islamic banks have started to emerge in Bangladesh, which fundamentally follows the Islamic Shariah laws. Shariah compliance has been very important for the Islamic financial system as Shariah compliance shows the transparency and integrity of the Islamic banks (Alam et al., 2020; Ab Ghani et al., 2019).

In this regard, the Shariah-based internal audit is an essential function to ensure Shariah compliance in Islamic financial institutions, and in fostering accountability and transparency of the financial system. The internal auditor's function is to assist the Islamic financial institutions in ensuring a proper internal control system is in place and the business operations are conducted efficiently, effectively, and economically. An effective internal audit system is perceived to be a strong pillar of the Islamic financial business since it helps to control and minimize financial risk and works as an internal controller of financial activities. (Khalid, 2020; Khalid et al., 2017).

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Besides, an effective internal audit system serves a fundamental purpose in promoting confidence and reinforcing trust in financial information (Omar & Bakar, 2012). If the internal Shariah audit is found to be effective, then it will ensure smooth corporate governance and keep track of possible financial risks. Accountability is one of the main issues in Islamic banking operations because Islamic banks must make sure that their operations do not go against Shariah principles. Thus, Shariah auditing is one of the important aspects of the operation of Islamic banks related to the Islamic bank's accountability and transparency (Shafii & Salleh, 2010). Shariah auditing has a very broad scope including many aspects beyond the financial matter and products of Islamic financial institutions. Shariah auditing also covers other aspects related to human resources development, marketing communication, and production process. (Yasoa et al., 2018).

Shariah audit is an independent assessment conducted periodically to improve the compliance and to ensure the effectiveness of the Shariah control system. Efficient conduct of Shariah audit will minimize Shariah non-compliance risks, promoting good Shariah practice in the Islamic banking sector. (Masruki et al., 2020). As the banking sector is facing enormous challenges, a strong and rigorous Shariah-based internal audit system will help retain customers' and stakeholders' trust in the Islamic banking sector (Grassa, 2013). One aspect that is still under-researched is the Shariah audit. In the absence of a proper framework and standards, this could dampen the future of Islamic financial institutions. Therefore, there is an urgent need to determine the factors that influence the effectiveness of the Shariah-based internal audit system. The study findings can be adopted as guidelines to improve the overall effectiveness of the Shariah-based internal audit system in Islamic financial institutions.

In the eagerness of providing products and services to customers, Islamic banks sometimes have overlooked certain matters that ultimately affect the Shariah-compliant nature. A Shariah-based internal audit performed by the internal auditor ensure that the overall processes and activities in Islamic banks do not contravene the Shariah Principle. In fact, the existence of the internal auditor function must be effective enough to ensure the control mechanism. Many scholars argued that Shariah audit effectiveness is very important for the sustainability of Islamic banks. The collapse of the financial industry in 2008 also indicates the need for having an effective audit system for any financial industry. All of these scenarios have pronounced the need for investing in improving the efficiency and efficacy of the internal audit system to avoid any future financial collapse (Algabry et al., 2020; Othman & Ameer, 2015; Ali et al., 2015; Badara & Saidin, 2013).

As Islamic-oriented financial activities have been growing around the globe, it is the responsibility of the

Islamic financial institutions to implement Shariah-compliant financial activities; this leads to the necessity of having a Shariah-based internal audit system. Persistently high expectations from the operations of Islamic financial institutions appear to give way for a gap to exist between "what ought to be" Shariah auditing and the current practice of Shariah audit (Aziz et al., 2019). While the need for highly trained and skilled manpower in the Islamic banking industry is well established, the main challenge is a mismatch of the talent pool between what is required by the banks and what is offered by the market. Prior research reveals that the competency requirements for Shariah auditors were still not developed even though there is a need for it. (Kasim et al., 2009). This research aspires to identify and determine the factors that would affect the effectiveness of the Shariah-based internal audit system of Bangladeshi Islamic banks.

## 2. Literature Review and Hypotheses Development

### 2.1. Shariah Audit Effectiveness (EFFC)

An audit program is an action plan that documents what procedures an auditor will follow to validate that an Islamic financial institution is in conformance with compliance regulations. An audit program can be described as effective if the outcome of the audit matches the given objectives (Ussahawanitchakit, 2012). An effective Shariah-based audit system refers to the capacity and capability of the Shariah auditors to attain the predetermined objectives of an Islamic financial institution (Khalid, 2020; Badara & Saidin, 2014). Mihret and Yismaw (2007) highlighted that internal audit effectiveness is strongly influenced by internal audit quality and management support, whereas organizational setting and auditee attributes do not have a strong impact on audit effectiveness. Feizizadeh (2012) stated that internal audit needs to demonstrate its effectiveness using a performance measurement system tied to the expectations of its key stakeholders. Only by circling back to the needs of its key stakeholders and regularly tracking its performance against the expectations of the board, senior management, and operating management, an internal audit function can satisfy increased scrutiny and more demanding, expectation. According to Al-Twajjry et al. (2003), audit experience, relevant educational achievement, and audit-related professional degree will enhance the efficiency and efficacy of an internal Shariah auditor. Alzeban and Gwilliam (2014) assessed factors influencing internal audit effectiveness in Saudi Arabia. Results suggested that management support for internal audit effectiveness drives the perceived effectiveness of the internal audit function from both management's and the internal auditors' perspective. Management support is linked

to hiring trained and experienced staff, providing sufficient resources, enhancing the relationship with external auditors, and having an independent internal audit department. Internal auditing has become an indispensable control mechanism in Islamic financial institutions. Yet very few academic studies have been conducted on the effectiveness of internal auditing. Support from top management is the main determinant of internal audit effectiveness, with some effect also found for the organizational independence of internal audit (Cohen & Sayag, 2010). Ahmad et al. (2009) recognized that limited training opportunities, anti-audit attitude from department managers, and lack of audit officials might hamper internal auditing capacity. Khalid et al. (2017) explored the role of the Audit and Governance Committee (AGC) for internal Shariah auditing's effectiveness in Bahrain's Islamic banks. They studied the AGC effectiveness by identifying roles, duties, and responsibilities of characterizing more active AGC and suggesting that these AGC could have a positive impact on internal Shariah audit effectiveness in Bahraini Islamic banks.

## 2.2. Autonomy (AUTY) of the Auditors

Generally, the internal audit section works as an autonomous department of any Shariah-based banking organization and their prime duties are to keep track of the banking activities concerning Islamic Shariah compliance and other non-financial issues. Shariah audit activities are managed by the Shariah board members and directors of the Islamic institutions who ensure that no outside interference may disrupt the internal Shariah auditing functions and Shariah auditor can perform auditing independently to achieve the overall objectives of the respective Islamic financial institution. Internal Shariah audit effectiveness could be enhanced by the Shariah board members' independence and experience. Due to the position of the Shariah board members as the ultimate oversight body in the Islamic financial institutions, the Shariah board members could influence internal Shariah audit effectiveness (Alzeban & Gwilliam, 2014). Hence, it is recommended that an autonomous and independent audit system needs to be reinforced by the management of the Islamic financial institutions for having better Shariah-compliant financial functions (Kasim et al., 2009). Shariah audit function is performed by internal auditors who have adequate Shariah related knowledge and skills. Shariah auditors should be able to demonstrate that there is no threat to their independence. It is also required that internal Shariah auditors need to be allowed to work with full authority to produce unbiased audit report which will be presented to the shareholders and other stakeholders of the Islamic banks. Internal Shariah audit function should be performed impartially, professionally and with due professional care to support internal Shariah

audit independence and competence. Shariah auditors are advised to strive for work autonomy for their unrestricted access to audit-related documents to produce an effective audit performance (Rahman & Rahim, 2011). Mihret and Yismaw (2007) stated that management support is one of the two most important factors (the other being internal audit quality) influencing audit effectiveness. The internal audit function of an Islamic financial institution should be given a sufficiently high status in the organizational structure to enable better communication with senior management and to ensure the independence of internal audit from the auditees. Independence is of paramount value in providing effective internal audit service to the management, for it affords an objective and uninhibited appraisal and reporting of findings without influence from the management. Hence, the following proposition is developed:

***H1:** Autonomy (AUTY) of the auditors will impact Shariah audit effectiveness (EFFC).*

## 2.3. Competency (COMP) of the auditors

Shafii and Salleh (2010) stated that internal Shariah auditors are supposed to obtain relevant and necessary audit-related expertise and understanding to perform auditing at Islamic financial organizations. Competency and work performance are positively significant with internal Shariah audit effectiveness. The main competency of an internal Shariah audit to influence effectiveness is to have professional certification and skills. (Shafii et al., 2010). Khalid et al. (2017) explained that Islamic and Shariah-based knowledge and information is the foremost skills for Shariah auditor to become an efficient Shariah auditor. It is necessary to enhance the competencies of internal audit staff through improving their professional qualifications, such as through education programs, certification, and relevant training on the scope of Sharia supervision. Such actions need to be done to support internal audit staff in performing the comprehensive supervision of Sharia compliance. Ali et al. (2007) conducted important research in Malaysian public institutions to evaluate the substance of internal audit works. For an effective system of internal control to exist, a well-managed internal audit department or unit is required whose activities are strongly supported by both management and other personnel within the organization. Ali et al. (2007) also propounded that the two greatest inhibitors to efficient and effective internal audit operations are the lack of audit personnel and the audit personnel's lack of appropriate skills and competency for the tasks required of them. Shariah-based training programs are key to amplify the effectiveness, functionality, and usefulness of internal audit work. Necessary audit competency in form of Shariah knowledge, training, and skills are perceived as the core characteristics

of an auditor at any Shariah-based Islamic bank. Thus, the following proposition is developed:

**H2:** Competency (COMP) of the auditors will impact Shariah audit effectiveness (EFFC).

#### 2.4. Work performance (WPER) of the auditors

Zain and Shafii (2018) highlighted Shariah governance factors affecting the performance of Islamic financial institutions. They discovered that the Shariah Committee (SC), Shariah risk, Shariah audit, as well as disclosure and transparency, were identified as governance measures linked to Islamic financial institutions' performance. It is expected that internal audit personal at Shariah-based financial institutions will operate their audit work in congruence with Shariah auditing fundamentals (Zain & Shafii, 2018). Shariah auditors would organize their workflow of audit actions, conduct audits in due time, and disseminate and present the audit results to the Shariah board of the Islamic banks (Khalid, 2020). In the performance of an audit, the objectivity of an auditor must be beyond question and the auditor must be able to audit effectively all financial items of the entire entity. The scope of the audit would be limited if the auditors were not in a position to comment on all areas of the affairs of the audited entity. To express an effective audit opinion, the auditors must possess sufficient technical skills and they must be qualified and competent enough to understand the criteria used (Siddiqui & Podder, 2002). Goodwin-Stewart and Kent (2006) also suggested that Shariah auditors should not only produce financial statements but are also required to reveal any other matter that they consider should be brought to the notice of the stakeholders. If the auditor feels that some events, that are material, have not been reported in the financial statements, it is his or her responsibility to expose such affairs. The assessment of materiality depends on the professional judgment of the auditor and should be influenced by the needs of the users of the financial statements. Rupšys and Boguslauskas (2007) asserted that internal auditing represents not just a detective means of control focused mainly on financial information and compliance, but rather a proactive function in the organization, encompassing assurance and consulting services. Internal audit adds value through the usage of a structured and systematic approach, enabling to evaluate and improve the effectiveness of risk management, control, and governance processes. Khalid et al. (2017) also affirmed that different aspects of audit performance would essentially trigger the continuation process of an effective Shariah-based internal audit system. Therefore, the following proposition is developed:

**H3:** Work performance (WPER) of the auditors will impact Shariah audit effectiveness (EFFC).

### 3. Methodology

This study has gathered the relevant data by adopting survey questionnaires which were developed based on prior studies. The study has undertaken a convenience sampling strategy, complemented by a purposeful sampling measure wherein the researchers relied on their judgment when choosing members of the population to participate in the study. A convenience sample is a type of non-probability sampling method where the sample is taken from a group of people easy to contact or to reach. From the research perspective, this study can be characterized as quantitative research. The survey questionnaires, consisting of 210 questionnaires with a request cover letter, were directly mailed to Shariah auditors, members of the Shariah board and the audit committee of six private Islamic banks in Dhaka, Bangladesh. 152 responses were received, out of which 136 were found complete and usable for this study, reflecting a feedback rate of 65%. Therefore, the sample size in this study is  $n=136$ .

The questionnaire has two parts, the first part includes questions on respondent's basic demographic information and the second part incorporates item-wise questions on study variables. The collected data was tested for validity and reliability. Every variable comprised a few inquiry things estimated on a five-point Likert scale, a type of psychometric response scale in which responders specified their level of agreement to a statement typically in five points: (1) Fully disagree; (2) Disagree; (3) Neither agree nor disagree; (4) Agree; (5) Fully agree. SPSS version 23.0 has been used to perform the study related statistical analysis (i.e., correlation and regression analysis). *Cronbach's alpha* is a measure of internal consistency, that is, how closely related a set of items are as a group. It is considered to be a measure of scale reliability. *Cronbach alpha* ( $\alpha$ ) values of 0.7 or higher indicate acceptable internal consistency (as shown in Table 1). Thus, the indicators that measure the variables are valid and reliable.

**Table 1:** Reliability Measurement of the Study Variables

Study Variables	Cronbach's ( $\alpha$ )
Effectiveness of internal Shariah audit (EFFC)	0.745
Autonomy of the auditor (AUTY)	0.803
Competency of the auditor (COMP)	0.742
Work performance of the auditor (WPER)	0.719



**Table 2:** Descriptive Information of the Respondents

Description	Frequency	(%)
<i>Gender</i>		
Male	119	87.5
Female	17	12.5
<i>Age</i>		
21 to 30 years	18	13.2
31 to 40 years	79	58.1
41 to 50 years	23	16.9
>50 years	16	11.8
<i>Professional Category</i>		
Shariah Auditor	88	64.7
Member of Shariah board	23	16.9
Member of the audit committee	25	18.4
<i>Academic Qualification</i>		
PhD	19	13.9
Master/Master Equivalent Degree	105	77.2
Bachelor Degree/Undergraduate	8	5.9
Diploma	4	3.0
(n=136)		

**Table 3:** Correlation Analysis

	Variables	Mean	Std. Deviation	EFFC	AUTY	COMY	WPER
1	Effectiveness of internal Shariah audit (EFFC)	3.8137	0.46679	1	0.470**	0.400**	0.451**
2	Autonomy of the auditor (AUTY)	4.0698	0.40122	0.470**	1	0.661**	0.503**
3	Competency of the auditor (COMP)	4.0630	0.31484	0.400**	0.661**	1	0.508**
4	Work performance of the auditor (WPER)	3.8672	0.38271	0.451**	0.503**	0.508**	1
[n=136; **p<0.01]							

#### 4. Results and Discussion

Table 2 displays the demographic information of the study respondents. The total number of samples in this study is 136, of which approximately 88% (n=119) of respondents are male respondents and only 12% (n=17) of respondents are respondents female. In terms of age, the majority of respondents are aged more than 30 years of age. This implies that the majority of Shariah auditors, Shariah board and committee members are in mid-age at the time of the survey. In terms of professional category, almost 65% (n=88) are working as internal Shariah auditor, 17% (n=23) are serving as a member of the Shariah board and 18% (n=25) are serving as a member of the Shariah audit committee. In educational attainment, 14% (n=19) had a doctoral degree

in their respective field of study, 77% (n=105) had a master or equivalent degree, 6% (n=8) had just completed their bachelor degree, and 3% (n=4) had achieved only a diploma certificate in their relevant field.

Table 3 shows the correlation analysis among the study variables. Table 3 reveals that all the independent variables are statistically correlated with the study dependent variable (effectiveness of Shariah audit) at a 1% significance level. Table 3 further describes that autonomy or independence of the auditor correlated with the effectiveness of Shariah audit ( $r=0.470$ ); competency of the auditor is significantly correlated with audit effectiveness ( $r=0.400$ ), and overall work performance of the auditor is significantly correlated with Shariah audit effectiveness ( $r=0.451$ ).

**Table 4:** Regression Analysis

	R <sup>2</sup> Change	β value	t-value	p-value	Tolerance	VIF
Autonomy of the auditor (AUTY)	0.285	.285	5.011	.000**	.526	1.902
Competency of the auditor (COMP)		.275	5.311	.019*	.522	1.916
Work performance of the auditor (WPER)		.269	5.436	.000**	.693	1.444
[n=136; **p<0.01; *p<0.01] Durbin Watson Value: 1.635						

Another step of assessment in the statistical analysis is R<sup>2</sup>, also called the coefficient of determination. The *coefficient of determination* is the proportion of the variance in the dependent variable that is predictable from the independent variable(s) (analyze how differences in one variable can be explained by a difference in a second variable). Table 4 illustrates the detailed and explanatory analysis of the regression coefficient value of this study. According to Table 4, 28.5 percent of the variance in the dependent variable (effectiveness of the internal Shariah audit) is explained by the independent variables (autonomy, competency, and work performance).

The Durbin Watson (DW) statistic is a test for autocorrelation in the residuals from a statistical regression analysis. The Durbin-Watson statistic will always have a value between 0 and 4. A value of 2.0 means that there is no autocorrelation detected in the sample. Values from 0 to less than 2 indicate positive autocorrelation and values from 2 to 4 indicate negative autocorrelation. The regression model reveals an acceptable range of Durbin Watson's value (1.635) and the tolerance value is below 1.00 for all independent variables. The variance inflation factor (VIF) and tolerance are two closely related statistics for diagnosing collinearity in multiple regression. They are based on the R-squared value obtained by regressing a predictor on all of the other predictors in the analysis. Tolerance is the reciprocal of VIF; small VIF values indicate low correlation among variables under ideal conditions. The VIF value range for all independent variables is below the acceptable value of 5.0, indicating there are no multicollinearity issues.

Table 4 also illustrates that the first hypothesis (H1) is accepted ( $\beta = 0.285$ ,  $p < 0.01$ ) at a 1% significance level, pointing out that independence or work autonomy of the Shariah auditor is extremely crucial for maintaining the effectiveness of the Shariah-based internal audit system. The regression model also shows that the second hypothesis (H2) is accepted ( $\beta = 0.275$ ,  $p < 0.05$ ), meaning that a higher competency level of the audit team will necessarily ensure an effective and efficient Shariah-based internal audit system. The third hypothesis (H3) states that the overall work performance of the Shariah audit team will positively affect the effectiveness of the Shariah-based internal audit

system and this hypothesis is accepted ( $\beta = 0.269$ ,  $p < 0.01$ ), which indicates the higher performance of the audit team, the greater the effectiveness of the Shariah-based internal audit system would be.

## 5. Conclusions

The present study attempts to understand and examine what factors might affect the effectiveness of the Shariah-based internal audit system and found that auditor's work autonomy, level of competency, and overall work performance significantly impact the effectiveness of the Shariah-based internal audit system. It is firmly believed that the study results would sufficiently add value in understanding the Shariah-based internal audit effectiveness of the Islamic banks. Since the effectiveness of the Shariah-based internal audit system is very crucial for Islamic financial institutions, this study also offers some relevant implications for the management committee members of Islamic financial institutions such as Islamic banks. To have an effective audit system in Shariah-based financial institutions, Shariah auditors need to be fully empowered so that they can conduct audits independently, without experiencing any internal or external interference. Shariah board members should also be encouraged to offer full freedom and authority to internal auditors to expedite their audit work. As the competency and performance of auditors will affect the effectiveness of the Shariah-based internal audit system, the managerial committee of Islamic banks should continuously provide necessary and relevant training and conduct workshops to enhance Shariah auditors' competency level and work performance. It can be expected that future studies may consider other determining factors of the effectiveness of the Shariah-based internal audit system such as technical knowledge of the auditor, job tenure of an auditor, inter-departmental collaboration, and support from top management and shareholders of the institutions.

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