INTERNAL AUDIT EFFECTIVENESS IN MALAYSIA INDONESIA: A CONCEPTUAL FRAMEWORK

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ABSTRACT

This study offers a conceptual framework on the internal audit effectiveness within zakat institutions in Malaysia and Indonesia. Generally, internal audit effectiveness can be derived based on the internal audit quality, support from management, structure of organization and attributes of the auditees. The critical role of internal audit functions among other are to provide transparency, integrity, quality and improvement to the organizations. Zakat institution is considered as one of the important element of the Islamic socio-economic system both in Malaysia and Indonesia. Although the top structure of zakat institution’s management varies between Malaysia and Indonesia, the ultimate objective is similar which is to administer sharia-based public funds. Moreover, the administration of zakat has received a considerable amount of attention by stakeholders such as related government bodies, zakat payers and researchers. Concepts from agency theory and institutional theory are used as the underlying theoretical framework. This study will contribute among others to compare the practices and the drivers of internal audit effectiveness in both countries. Examining the drivers of the diverse approaches used in each country might has important implication towards zakat management reform and the role of internal auditors.

Key words: Internal audit effectiveness, Zakat institution, Malaysia, Indonesia

INTRODUCTION

Internal auditing has undergone a paradigmatic shift including the activities undertaken that giving add more value to organizations (Arena & Azzone, 2009). Generally, internal audit effectiveness can be derived based on the internal audit quality, support from management, the structure of organization and attributes of the auditees (Mihret & Yismaw, 2007). The quality of internal audit incorporates the size of the internal audit that could determine the level of work to be performed besides the level of competencies (Al-Twajiry, Brierley, & Gwilliam, 2004). The commitment from the management by giving support to internal audit is significantly important to audit effectiveness (Sawyer, 1995). The structure of the organization consists of the element of the profile of the organization, the level of the budget of internal audit unit together with the policies and procedures towards the operation of internal audit (Mihret & Yismaw, 2007). The ability of the auditee towards the work of internal auditor and cooperation given refers to the auditee attributes. (Mihret & Yismaw, 2007).

Zakat institutions act as an authoritative body that is anticipated to be well managed in particularly to provide services to the public especially to those who are eligible to receive funds. Within the context of Islam, zakat institutions are crucial when deciding to distribute funds from the rich (muzakki) to the poor (duhaa) (Amalia, Rodoni, & Tahlilani, 2018). Similar to other types of organizations which embedded the good principles of corporate governance, zakat institutions are also subject to implement proper control such as using the internal audit to assist in managing zakat. The incorporation elements of trustworthiness (amanah), transparency, accountability and Sharia compliance (Amalia et al., 2018) and the principle of oneness of Allah (tawhid) (Ahmad & Rashid, 2016) made the zakat institutions unique from other types of organizations. Accordingly, among of the issues faced by zakat institutions is loss of public trust (Hussain, Idris, & Saad, 2018) such as complaints on zakat distributions (Mohd Harzrud, 2010), dissatisfaction towards the management of the institutions (Adzrin, Ahmad, Marzuki, Othman, & Sufiyudin, 2015) and thinking the abuse of zakat fund (Sanep & Hairunnizam, 2005).

Zakat institution which part of non-profit financial institution act as an authoritative body has an important role in the economic system (Khan 1995 as cited in Abd. Wahab & Abdul Rahman, 2011). For instance, the accumulated collection of zakat by Pusat Pungutan Zakat Agama Islam Wilayah Persekutuan (PPZ-MAIWP) from 1991-2018 was RM6.029 billion (MAIWP, 2018). According to Muhammad Ali, Samiun, Ahmad, & Mat Zain (2016), the collection of zakat in Indonesia is around RM650 million with estimated by the Badan Amil Zakat Nasional (BAZNAS) and Islamic Development Bank (IDB) in 2012 up to RM58 billion. The critical role of internal audit functions among others includes providing transparency, integrity, quality and improvement to the organizations (Baharuddin, Shokiyah, & Ibrahim, 2014). Thus, internal audit effectiveness could play a role as a dynamic process aligning the challenges faced by the organization such demands from the stakeholders. This study presents a conceptual model on the internal audit effectiveness in two zakat institutions namely Lembaga Zakat Kedah in Malaysia and BAZNAS of West Java Province in Indonesia based on the internal audit literature, agency theory and institutional theory.

LITERATURE REVIEW

Internal Audit and Internal Audit Effectiveness

According to Chartered Institute of Internal Auditors (CIIA), the role of internal audit ‘is to provide assurance that an organization’s risk management, governance and internal control processes are operating effectively’ (Chartered Institute of Internal Auditors, 2019, p. n). Furthermore, internal auditors are crucially important in order to ensure the continuity and
prosperity of organizations. In the context of the development of internal auditing practices, the role of internal audit changed from examining financial statements and fraud investigations to emphasis more on efficiency and economy audit besides giving recommendations to management or add more value (Arena & Azzone, 2009; Sarenes & Beelde, 2006). In the modern era of internal auditing, the three elements known as three ‘E’s’ of Effectiveness, Efficiency and Economy dominated the practices of internal audit (Lenz & Hahn, 2015). Effectiveness refers to ‘doing the right thing, efficiency means ‘doing them well’ and economy refers to ‘doing them cheaply’ (Chambers, 1992 as cited in Lenz & Hahn, 2015, p. 6). According to Lenz, Sarenes, & Jeppesen (2018), effectiveness is considered the important elements among the three ‘E’s’ as if the internal audit is not effective, ‘it does not matter how efficiently or economically the service is rendered’ (p. 4). Additionally, Dittenhofer, (2001) acknowledges that effective internal audit could assists organizations to meet their objectives despite the need to use a proper measurement to confirm effectiveness due to auditing that considered as credence services.

According to Lenz et al. (2018), internal audit effectiveness is highly debated in practice, however, the issue of internal audit effectiveness still needs to be examined in academic research. The authors review two streams of internal auditing effectiveness literature namely the supply-side perspective (self-assessment of internal auditors) and the demand-side perspective (other stakeholder’s perspective) based on new institutional theory and institutional entrepreneurship. Furthermore, more research needs to be conducted on internal audit effectiveness particularly in developing countries (Ahmad, Othman, Othman, & Jusoff, 2012; Al-Twaipjrjy et al., 2004; Arena & Azzone, 2009; Endaya & Mohd Hanefah, 2013; Mihrer & Yismaw, 2007).

Zakat Institutions in Malaysia

Zakat management in Malaysia is govern by the State Islamic Religious Council (SIRC) which different zakat law or enactment applied between each states and limited role by the federal government (Ahmad Razimi, Romile, & Muhamad Erdris, 2016; Shamsuddin, Mustaftha, & Johari, 2017) with the exception of state of Kedah which directly under the Majesty known as Lembaga Zakat Negeri Kedah (LZNK) (Ab Rahman, Alias, & Omar, 2012). In total, there 14 zakat institutions over Malaysia consist of 13 states and one for Wilayah Persekutuan Kuala Lumpur. Back in 1991, the zakat institution in Wilayah Persekutuan Kuala Lumpur has been corporatized followed by Pahang, Selangor and Penang in 1995, Sarawak in 2001, Negeri Sembilan and Melaka in 2006 lastly Sabah in 2007 (Ahmad Razimi et al., 2016; Ahmad, Wahid, & Mohamad, 2006). The corporatization of the zakat administration outlines among others; to provide specified offices, officers or counters for collection of zakat separately from SIRC; to utilise the state-of-the-art in computer technology in all zakat related dealings; to set up a corporate working system which is not bound by bureaucracy. In this way it would encourage innovation, creativity, proactive and expedite the delivery system (Ab Rahman et al., 2012).

The literature on zakat institutions in Malaysia has been conducted by e.g. Ab Rahman et al. (2012) on the identification of problem and issues of zakat management, Ahmad & Shofian (2010) on zakat transformation, Saneq Ahmd et al. (2006) on the effects of zakat corporatization practices, Hussain et al. (2018) on service quality, Abd. Wahab & Abdul Rahman (2011) on the efficiency and governance, and Adzri et al. (2015) on the satisfaction level of zakat recipients. Among of the findings of those studies indicate that zakat institutions play an important role particularly in Islamic economy and a steady change in term of managing zakat. However, other findings suggest that zakat institutions need to ensure some improvement such as the issues service quality, the dissatisfaction of public and efficiency of zakat distributions.

A number of studies e.g. Rahman & Jusoh (2018) highlight the importance of effective audit quality and effectiveness of internal audit towards zakat distribution performance, Shamsuddin et al. (2017) recommend higher number of internal auditor with certain experiences especially in financial reporting, and Shamsuddin, Zaini, Mustaftha, & Johari (2018) suggest that organizational status and competency of internal audit are important in internal audit effectiveness. However, most of those studies are lack of applying related theory except Rahman & Jusoh (2018) that apply agency theory.

Zakat Institutions in Indonesia

In Indonesia, there are two main zakat institutions formed by either by non-government organizations and central government (Wulan, Khairunnisa, & Bahri, 2018). The authors further mention that the Ministry of Religion of Indonesia divided the institutions established by non-government organizations according to the amount of zakat collected namely, National Lembaga Amil Zakat (LAZ), Provincial LAZ and Regency LAZ, respectively. Under the central government, zakat institution is referring to Badan Amil Zakat Nasional (BAZNAS) which governed by the Presidential Decree Number 8 in 2001. This study will focus on the BAZNAS located in West Java.

Extensive studies on zakat has been carried out in Indonesia e.g. Lessy (2009) on the need for collaboration to standardize zakat management formed by non-government organizations and the central government, Hafidhuddin & Bei (2010) on the issues faced such as the gap between estimation and collection of zakat, Firdaus, Bei, Irawan, & Juanda (2012) on the drivers that influence zakat payment and Firmanarya & Devi (2017) on the need to implement good corporate governance for zakat institutions.

Additionally, some specific studies related to internal audit and zakat include Hakim, Bei, Pramono, & Saoqi (2019) that recommend the implementation of Shariah Governance Standards including internal audit at national level, Wulan et al. (2018) on the important of internal audit to conduct information technology-based audit particularly in digital zakat finance, Amalia et al. (2018) on applying elements of good governance such as internal and external audit (financial, managerial and Sharia) and Megawati (2018) recommends to have sharia audits in zakat institutions.
THEORETICAL PERSPECTIVES

Agency Theory
According to Institute of Chartered Accountants in England & Wales (ICAEW), (2005), ‘an agency relationship arises when one or more principals (e.g., an owner) engage another person as their agent (or steward) to perform a service on their behalf’ (p. 6). In other words, the responsibility delegated by the principal to the agent is important in helping organizations such as to achieve efficiency and economy productivity. However, such delegation also means that the principal needs to place trust in an agent to act in the principal’s best interests. In this context, the formation of the audit committees, and the external and internal auditors will assist organizations in to improve their performance besides monitoring the operation by the management to procedures (Adams, 1994). Internal auditors as agents need to conduct auditing at the professional level by having appropriate education and professional certifications, experience, and other competencies (Endaya & Mohd Hanefah, 2013) Having internal auditors with such requirements and the existence of training programs for internal auditors, would increase the confidence level of the management and audit committee. As an agent, internal auditor requires supports from an organization such as having an effective audit committee to enhance the level of independence and to ensure internal audit recommendations are being taken by the members of the organization (Endaya & Mohd Hanefah, 2013). Additionally, internal audit has an advantage over external audit in acquiring information quickly and detecting problems earlier (Mihret & Yismaw, 2007).

Institutional Theory
An institution is defined as a social structure consisting of a group of individuals or organizations within which collectives exercise action or orientations in a constrained environment that will continuously be changed over time (DiMaggio & Powell, 1983; Meyer & Rowan, 1977; Scott, 1987). According to DiMaggio & Powell (1991), institutional analysis is ‘neither to expose the inefficiency of organizational practices nor to celebrate the non-optimality of institutional arrangements…but to develop robust explanations of the ways in which institutions incorporate historical experiences into their rules and organizing logics’ (p. 33). According to DiMaggio & Powell (1983, p. 148), organizational field refers to “those organizations that, in the aggregate, constitute a recognized area of institutional life: key suppliers, resource and product consumers, regulatory agencies, and other organizations that produce similar services or products”. For example, the sources of organizational practices in a field are regulation and technology (Meyer & Rowan, 1977).

In accounting literature, NIS perspective on institutional theory is ‘primarily concerned with an organization’s interaction with the institutional environment, the effects of social expectations on the organization, and the incorporation of these expectations as reflected in organizational practices and characteristics’ or ‘a way of thinking about formal organization structures and the nature of the historically grounded social pressures through which these structures develop’ (Dillard, Rigsby, & Goodman, 2012), the three common themes of early NIS based research were legitimacy, isomorphism, and decoupling. Thus, the current study will focus on the concept of institutional isomorphism, which relates to coercive, mimetic, and normative pressures.

Within the internal audit studies, (Al-Twaijry et al., 2004) use isomorphic pressures (coercive) to examine internal audit in Saudi Arabia, similarly, (Arena & Azzone, 2009) conclude that the three isomorphic pressures significantly effect on the adoption and development of internal audit in Italy, and Mihret, James, & Mula (2010) propose that institutional theory could be used to identify the factors on internal audit effectiveness. Thus, both agency theory and institutional theory could provide additional insights and be used to examine the internal audit effectiveness.

Proposed Conceptual Framework
Based on the study Mihret et al. (2010), Baharuddin, Shokiyah, & Ibrahim (2014) and (Endaya & Mohd Hanefah, 2013), several potential drivers towards internal audit effectiveness are organizational attributes, risk exposure, management support, auditee cooperation, competency, and relationships between internal and external audit. The goals, management and operation in activities and stakeholders of an organization in different sectors could vary due to different institutional pressures faced in different sectors. For example, Jacobs (1998) suggests that value for money audit is influenced by institutional context. The type of organizations may also affect the internal control procedures and the level and type of services provided by internal auditor (Roth, 2002). As a result, the services required from internal auditors may differ by type of organizations.

The used of internal audit depends on the level of risk faced by organizations (Felix, Gramling and Maletta, 2001). For instance, managements require services from internal auditor may be greater when organizations are exposed to high risk. Thus, internal auditor could outline the appropriate risk management strategies to align its plans with organizational objecti (Selim and McNamee, 1999). As different organizations may be exposed to different levels of risk, the demand for internal audit could be different based on the risk faced (Arena et al., 2006).

According to Mihret & Yismaw (2007), support from management is important for internal audit effectiveness such ensuring the appropriate resources are given to internal audit. Additionally, the ‘tone at the top’ at organization will ensure the level of cooperation between auditees and auditor is acceptable. Lastly, organizational policy on internal audit’s charter will provide a clear support by management towards internal audit activities. Mihret et al. (2010) argue that internal audit profession needs to improve their services when there are pressures such from professional accounting bodies that will lead to the existence of normative pressures. External audit also indirectly impacts the development of internal audit as external audit can be a market for the employment of internal auditor (Al-Twaijry et al., 2004; Arena, Arnaboldi, & Azzone, 2006)

Competency refers to the ability of an internal auditor to perform a job or task properly through having a set of defined knowledge, skills and behavior (Chartered Institute of Internal Auditors, 2019). Additionally, competency include educational
background, professional qualification, sufficient number of staff and exercise due professional care that could determine the audit quality (Shamsuddin et al., 2018).

Based on the literature, the current study will adopt research models by (Baharuddin et al., 2014; Endaya & Mohd Hanefah, 2013; Mihret, James, & Mula, 2010). Additionally, the current study will include variables based on the use of shariah audit, other zakat institutions, professional bodies and associations, and media as shown in Figure 1.

**Figure 1: Proposed Conceptual Framework**

Shariah audit refers as ‘an examination of the extent of Islamic Financial Institutions (IFIs) compliance, in all their activities, with the Shariah’ (Khalid, Haron, & Masron, 2018, p. 201). The use of shariah audit becomes important as the level of awareness among IFIs are growing including to contribute towards achieving the objectives of Islamic law, the Maqasid al-Shariah (Shahul & Yaya, 2005). For instance, internal shariah auditors need to certify that the related Islamic activities are free from negative elements that may create injustices, such as Riba, gambling fraud and corruption (Mustafa, 2011). Within institutional isomorphism of mimetic and normative pressures could exist when organizations imitating other organizations and stems from the professionalism of education and professional networking, respectively (DiMaggio & Powell, 1983). The current study will use other zakat institutions, professional bodies and associations besides media to examine the effects of institutional pressures.

**DISCUSSIONS AND CONCLUSIONS**

This study proposes that agency theory, institutional theory besides other variables such as Islamic perspectives could be used in understanding and developing a conceptual framework towards internal audit effectiveness. As indicated in the literature, studies that apply appropriate theories on internal audit effectiveness are very limited. Zakat institutions become important towards national economy and it is timely that such process of monitoring and controlling the institutions need in place. Similar to the practices by private and public sector, a good corporate governance is needed. One of tools is to have internal audit that are effective to assist the institutions to meet their objectives. The elements of both agency theory and institutional theory could provide theoretical explanation in term of internal and external pressures. This study will contribute among others to compare the practices and the drivers of internal audit effectiveness in both countries. Examining the drivers of the diverse approaches used in each country might has important implication towards zakat management reform and the role of internal auditors.
Additionally, the elements of variables from Islamic perspective could enhanced the understanding towards internal audit effectiveness in religious institutions.

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