The Impact of External Shari'ah Auditing on the Efficiency of Jordanian Islamic Banks Performance

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Abstract

This study aimed to explore the impact of external Shari'ah auditing on the efficiency of Jordanian Islamic banks performance. This study has used SEM to analyze collected data from auditors and employees in Islamic banks in Jordan. This study has used a questionnaire to explore the perception of external Shari'ah audit of Islamic banks in Jordan, then the model estimated, after dropping the variables show good model fit indicators. this study examined the effect of Shari'ah audit through eight construct and found that, seven constructs significantly affect Islamic banks performance, i.e. planning, risk assessment, materiality assessment, sampling, internal controls-testing, evaluation of observations and Shari'ah non-compliances, using the work of relevant internal functions leads to better efficiency of performances in Islamic banks, except internal control-assessment. This study has practical and significance contribution for Islamic banks about of importance external Shari'ah auditing on its efficiency.

Keywords: external Shari'ah auditing, Islamic Banks, SEM, Jordan

1. Introduction

External Shari'ah Audit is an external control tool designed to form an independent opinion by the Shari'ah Supervisory Board regarding the commitment of the banks management to which extent employees and departments comply with principles of Islamic Shari'ah and the regulations and recommendations of the Fatwa Board and the organizations regulating the profession, and to report thereon to the General Assembly through an independent auditor. Accounting and Auditing Organization for Islamic Financial Institutions "AAOIFI", 2018; Al-Khulaifi, 2004; Mohammad, 2009)

External Shari'ah auditing is one of the most important indicators of the credibility of Islamic banks and the extent to which their applications are compatible. However, in the absence or weakness of the function of Shari'ah auditing, Islamic banks become mere slogans that lack credibility.

External Shari'ah Auditing Standard number six provides special process to ensure the quality of the Islamic banks commitment with the principles of Shariah (AAOIFI, 2018)

The Shari'ah standards provides a guide for professionals in charge of external Shari'ah audits of Islamic banks in line with international best practices as an important part of the governance of the Islamic financial industry, which in turn enhances the confidence of the owners' interests.

The importance of Shari'ah auditing is increased consciousness in Islamic institutions that each institution should contribute towards achieving and complying with the objectives of the Islamic law (Shahul and Yaya, 2005).

The general objective of this study is to provide knowledge, better understanding and insights into Islamic practices for evaluation efficiency of Islamic banks performance in accordance with Shari'ah standard number six. Thus, we examined the effect of external Shari'ah auditing on Islamic Banks performance in Jordan, specially, in a very important and fast-growing sector; such as Islamic banks in Jordan.

2. Literature Review

Shari'ah Standard number six is issued to provide an advisory guide for professionals engaged in external Shari'ah auditing of Islamic financial institutions, it was issued in line with international best practices as an important part of the governance of the Islamic financial industry, which in turn enhances stakeholder confidence

and integrate practices in relation with the processes and quality improvement and harmonize global practices of external auditing.

One of the unique tasks played by the external auditor, besides performing the financial statements audit, is to test Shari'ah compliance in Islamic banks. The audit process include a structured, documented plan involving a series of steps beginning with planning the audit and ending with issued the external audit report as to make sure the financial statements are prepared in accordance with the fatwa guidelines were issued by the Shari'ah Supervisory Board (SSB)**,** the accounting standards of the AAOIFI, and relevant national accounting standards and practices in the country in which auditor operates (Arwani, 2018).

(Kurd, 2010) claimed that financial performance and efficiency have to be measured regularly, hence performance measurement is considered as a major requirement to maintain the growing and sustainability of the Islamic banks (Qasim, Mohamad and Ibrahim, 2017).

The efficiency and profitability of Islamic banks through globalization phenomenon has put Islamic banks in competition with traditional banks in well-developed financial markets, (Bashir, 2001), so the performance evaluation of Islamic banks is especially important due to type of clients of Islamic banks.

Most of the prior studies highlighted the external Shari'ah audit and the Shari'ah Auditing Standard number six with the Islamic banks performance in general, while this study addresses the relationship between that standards and the Islamic banks performance, through addressing the most main requirements performed by the external Shari'ah auditor i.e. planning, Risk assessment, Materiality assessment, Sampling, Internal control - assessment, Internal controls-testing, Evaluation of observations and Shari'ah non-compliances and Using the work of relevant internal functions.

3. External Shari'ah Auditing

- *Planning*

Shafii, Salleh and Shahwan (2010) argued that effective planning, as procedure by auditors is necessary to determine whether reasonable assurance to achievement of Shariah compliance objectives. So auditors will start plan each review assignment and the documentation (Haniffa, 2010).

- *Risk assessment*

Rahman, Alsmady, Ibrahim and Muhammad (2014) claimed that usually the risk assessment is considered as one of the most challenging tasks. Comprehensive and systematic procedures of risk identification are essential in ensuring the accuracy of risk assessment (Chapman, 1998). The principles of the bank's risk management policies it's ensure risk assessment and monitoring is strictly independent from the business lines (Swartz, 2013).

- *Materiality assessment*

AAOIFI defines the materiality of information as follows: "Information is material if its omission or misstatement could influence the decisions that users make on the basis of an IFI's financial information" AAOIFI, 2011).

In Islamic perspective, materiality considers any information that will indicate justice in valuation and implement of the rights of Allah, society and individuals concerned (Haniffa, Hudaib and Mirza, 2004).

Information either qualitatively or quantitatively that is materiality should be presented for Islamic Banks and Financial Institutions , that materiality and adequate disclosure are interrelated and relate to the characteristic of relevance and reliability(AAOIFI, 2011).

- *Sampling*

The external Shari'ah auditor should be used the statistical methods and judgment with consider to risk of Shari'ah non-compliance. The sample size should be increased adequately (Merah, 2017).

- *Internal control-assessment*

During the process of planning and implementing the related process, the external auditor should be apply sufficient procedures to obtain a description of the control risks and then evaluate them. Internal control procedures reduce process diversity to lead more predictable outcomes (Sultana and Haque, 2011). Internal control system is important for Islamic banks to achieve their objectives.

- *Internal controls-testing*

Internal control effectiveness defined as objective to ensure a sound and effective appropriate internal control system of Shari'ah compliance (Khalid & Sarea, 2018; Rahman, 2011). The audit program and audit plan should be at least have specific procedures to test the Islamic banks internal controls (Ginena & Hamid, 2015).

-. Evaluation of observations and Shari'ah non-compliances

The Shari'ah Committee playing as supervisor role on Shari'ah issues related to the institution's operations and activities, this should be achieved by the Shari'ah review and the Shariah audit functions, usually Shari'ah review reports and the Shari'ah audit observations should enable the Shari'ah Committee to spotlight matters that require corrective measures (Ginena & Hamid, 2015).

- Using the work of relevant internal functions

Internal functions are the internal Shari'ah auditor, Shari'ah review and the report of Shari'ah observers, additional to evaluate the reliability and level of independence. The basis of the evaluation is the statement of relative independence from management, the receipt of the reports issued and then the review during the period of the related process. International financial institutes that have internal Shari'ah audit are more effective and efficient than those do not have such functions to mitigate fraud in their institutes, then an effective internal Shari'ah auditor is the one who aid international financial institutes in achieve their objectives (Khalid & Sarea, 2018).

4. Methodology

We used to analyze SEM by Analysis of Moments Structure (AMOS) and software SPSS to test another processes.

4.1 Sampling

This study collected data from two sources; first, it contacted Islamic banks auditors; second, it contacted employees in Islamic banks in Jordan.

This study has developed a questionnaire to explore the perception of external Shari'ah audit of Islamic banks in Jordan we initially started to measure the constructs based on the analysis of prior studies in order to ensure content validity, then, the design is enhanced by the insight gained from discussions with experts, academics and professionals,

The survey was of two parts, the first part consisted of 54 questions, related on latent factors, and the second part consisted of 5 questions, related to the demographic factors. The individuals who answered this survey were auditors and Islamic banks employees in Jordan (35 banks employee and 72 auditors). 119 surveys were collected, while only 107 questionnaires valid. The variables were measured by a 5-Likert scaled as 1 (strongly disagree) to 5 (strongly agree). Hair, Anderson and Tatham (1998) recommended that 100 is the minimum sample size to ensure the appropriate use of maximum likelihood estimation in SEM.

4.2 Hypotheses Statement

Eight testable hypotheses were summarizing as proposed. The following hypotheses were generated for this study:

H_1. *Planning is significantly affects efficiency of Islamic banks performance.*

H_2. *Risk assessment is significantly affects efficiency of Islamic banks performance*

H_3. *Materiality assessment is significantly affects efficiency of Islamic banks performance.*

H_4. *Sampling is significantly affects efficiency of Islamic banks performance.*

H_5. *Internal control-assessment is significantly affects efficiency of Islamic banks performance.*

H_6. *Internal controls-testing is significantly affects efficiency of Islamic banks performance.*

H_7. *Evaluation of observations and Shari'ah non-compliances is significantly affects efficiency of Islamic banks performance.*

H_8. *Using the work of relevant internal functions are significantly affects efficiency of Islamic banks performance.*

The conceptual framework proposed for this study is shown in Figure (1). It is develop from the literature review related of Shariah Standard number six is issued from AAOIFI.

5. Result

Structural equation modeling (SEM) was used to analyze the model. At the beginning, the measurement study model was examined in order to instrument validation, followed by an analysis of the structural model for testing all hypotheses, then, the measurement models with all 54 items were evaluated using confirmatory factor

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analysis. Evaluating the total measurement model showed that model fit indicators did not have acceptable values. Therefore, the model needed modifications.

Therefore, the some variables dropped from the model. The results of the model estimate, after dropping the variables show good model fit indicators.

Thus, confirmatory factor analysis of External Shari'ah Audit of Islamic Banks (54 items), after having done the confirmatory factor analysis the results showed that (EP1, EP3, EP8, EP10, EP11, EP12, PL5, RA1, RA3, MA2, MA4, SA2, SA4, IA1, IA2, IA6, IT3, EO5, EO6 and UF3) were dropped, while the other remaining items (EP2, EP4, EP5, EP6, EP7, EP9, PL1, PL2, PL3, PL4, RA2, RA4, RA5, MA1, MA3, MA5, SA1, SA3, SA5, IA3, IA4, IA5, IT1, IT2, IT4, IT5, EO1, EO2, EO3, EO4, UF1, UF2, UF4and UF5) were analyzed and showed that all the items have a factor loading of more than .50 (Hair, Black, Babin, Anderson, & Tatham, 2010).

5.1 Normality Test

Normality test was carried to test whether data obtained is normally distributed based on skewness and kurtosis. George and Mallery (2010) suggested that the acceptable range for skewness and kurtosis is + 2, according to Kline (2015) an absolute value greater than 3 is considered skewed, while for kurtosis value should be within the range of ±3 (Kline, 2005).

Table 1. Assessment of normality

Construct	Skewness	c.r.	Kurtosis	c.r.
EP2	-0.383	-1.618	-0.154	-0.326
EP4	-1.012	-4.274	2.789	5.908
EP5	-0.941	-3.972	1.067	2.252
EP6	-0.987	-4.167	1.437	2.844
EP7	-0.580	-2.450	0.593	1.252
EP9	-0.77	-3.270	0.971	2.050
PL1	-1.003	-4.353	0.977	2.062
PL2	-1.060	-4.477	1.632	3.445
PL3	-0.668	-2.822	0.563	1.190
PL4	-0.601	-2.538	0.957	2.020
RA2	-0.421	-1.776	0.372	0.786
RA4	-0.579	-2.446	0.073	0.154
RA5	-0.646	-2.728	0.458	0.967
MA1	-0.815	-3.444	0.479	1.012
MA3	-1.091	-4.609	0.757	1.597
MA5	-1.009	-4.263	0.990	2.091
SA1	-0.384	-1.623	0.165	0.348
SA3	-0.389	-1.643	0.280	0.591
SA5	-0.438	-1.849	0.153	0.324
IA3	-0.058	-0.243	-0.469	-0.989
IA4	-0.372	-1.571	-0.740	-1.562
IA5	-0.348	-1.496	1.130	2.386
IT1	-0.551	-2.327	-0.112	-0.236
IT2	-0.229	-0.968	-0.532	-1.124
IT4	0.047	0.200	-0.821	-1.733
IT5	-0.176	-0.745	-0.487	-1.029
EO1	-0.909	-3.837	0.981	2.070
EO2	-0.838	-3.539	1.704	3.597
EO3	-0.614	-2.592	0.165	0.349
EO4	-1.044	-4.409	1.686	3.560
UF1	-0.497	-2.097	0.884	1.866
UF2	-0.499	-2.108	0.552	1.166
UF4	-0.694	-2.932	1.687	3.563
UF5	-0.629	-2.658	0.975	2.058

Table 1 shows maximum value for skewness is 0.47, and minimum value -1.091. , while maximum value for kurtosis is 2.789, and minimum value -0.821, thus, it is assumed that variables are normally distributed.

5.2 Reliability and Convergent Validity

Testing reliability and validity of constructed model was done by using Cronbach's alpha value, composite reliability (CR) and average variance extracted (AVE).

Cronbach's alpha value should be more than 0.7 to represent a good reliability (Hair et al., (2010); Khalid and Amjad, 2012; Berthoud, 2000; Cronbach, 1971), as per Hair et al., (2010) the AVE represents should be more than 0.5 to be considered valid.

Table (2) shows that the model fulfills all the conditions for reliability and validity test. In additional VIF test was less than 3, which the model proved to be free of multicollinearity, or as correlation less than 0.8, the model proved to be free multicollinearity (Hair et al., 2010), where the max correlation between the variables was 0.775.

To check the adequacy of sample for factor analysis, for KMO, the value should be higher than .5 in order to accept for factor analysis, and the result for Bartlett's test has to be significant in order to accept that the variables are correlated.

Table 2. Reliability & validity

Construct	Cronbach's Alpha	AVE	CR	VIF
Efficiency of Islamic Banks performance	0.891	0.611	0.904	-
Planning	0.901	0.738	0.919	2.799
Risk assessment	0.890	0.736	0.893	1.834
Materiality assessment	0.908	0.770	0.909	1.217
Sampling	0.933	0.763	0.906	1.063
Internal control-assessment	0.888	0.745	0.897	1.733
Internal controls-testing	0.917	0.721	0.912	2.655
Evaluation of observations and Shari'ah non-compliances	0.855	0.576	0.844	2.093
Using the work of relevant internal functions	0.878	0.666	0.888	1.825

Note: Maximum Likelihood analysis with Kaiser normalization, varimax rotation KMO = 0.856; Bartlett's test   of sphericity =χ2=4665.989, df 1431 (p=0.000) (SPSS 22.0).

5.3 Structural Model

Structural model was developed to ensure that all instruments are fit for the model, to test hypotheses for casual effect to obtain the coefficient of R^2. The paths of causality between the underlying exogenous and endogenous constructs were specified in the structural model. The direct effect is that goes directly from exogenous construct to endogenous construct.

Endogenous constructs include efficiency of Islamic banks performance, whereas exogenous construct included external Shari'ah audit (i.e Planning, Risk assessment, Materiality assessment, Sampling, Internal control-assessment, Internal controls-testing, Evaluation of observations and Shari'ah non-compliances, using the work of relevant internal functions)

The hypothesized structural model was specified by including the constructs after its validation, and was tested in the next step, including eight paths representing the hypotheses (H_1, H_2, H_3, H_4, H_5, H_6, H_7 and H_8). To test the hypotheses, we follow recommend five fitness indexes for measurement. The absolute fit indices, incremental fit indices and parsimonious fit indices. Values of absolute fit indices require significant of χ2 more than 0.05 and RMSEA less than 0.08 and RMR or SRMR less than 0.08. Incremental fit indices aforementioned TLI more than 0.95, CFI more than 0.95. Furthermore, Parsimonious fit recommended retain χ2/df less than 3 (Hair et al., 2010; Kline, 2010; Chau & Hu, 2001; Tabachnick & Fidell, 2007; Hu & Bentler, 1999; Hooper, Coughlan, & Mullen, 2008)

The process resulted in deleting (20) items without effecting the content of Shari'ah audit for Islamic bank implementation. The remaining constructs and items are still significant in the modified model to test the Shari'ah audit for Islamic bank implementation construct indicates are correlated. The modified measurement model as shown in Figure (1), was found to be acceptably fit the data and represented with (34) items. The

chi-square (χ2) was 524.774 with degrees of freedom (df) of 483 and p value 0.092, the TLI = 0.983, CFI = 0.985, RMSEA = 0.029, RMR = 0.027, SRMR = 0.053 and (χ2/df) = 1.086., all the values are in the recommended range for indices for the measurement model. The standardized factor loadings are all above 0.70 and no large standardized residuals covariance. Therefore, the results support measurement model of Shari'ah audit for Islamic bank implementation.
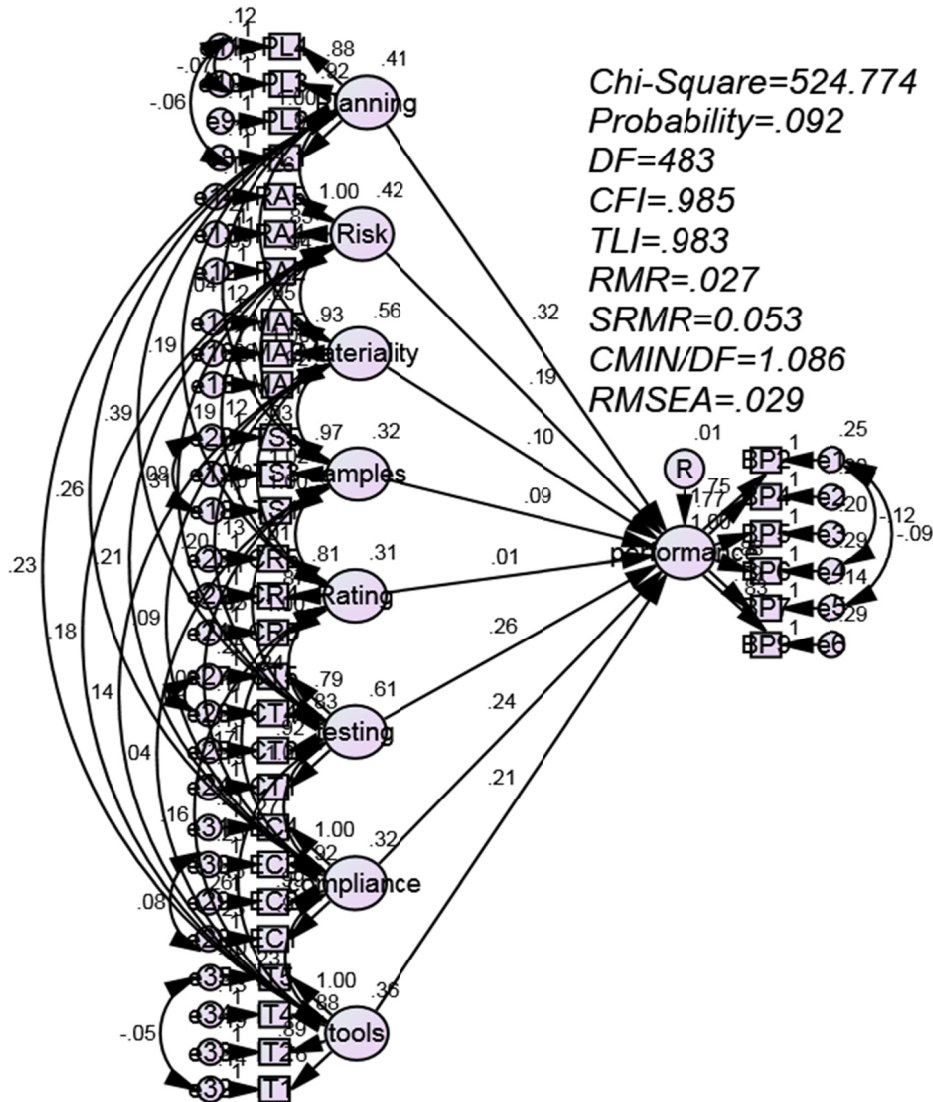

Figure 1. Structural model estimation

Figure 1 presents the factor loadings for items in the measurement model for the Impact External Shari'ah Audit on Efficiency of Islamic Banks Performance.

5.4 Hypothesis Testing

The direct effect represents the effect from exogenous construct endogenous construct, Figure (1) and Table (3), shows that the hypotheses test, in determining the significance of each path coefficient, estimate of regression weight, standard error of regression weight, and critical ratio for regression weight, were used.

Table (3) demonstrated planning construct has a significant positive and direct impact on efficiency of Islamic banks performance (β =0.323, C.R = 4.337; P<0.001) indicating that H1 is accepted.

Similarly, risk assessment construct has a significant positive and direct impact on efficiency of Islamic banks

performance (β =0.188, *C.R* = 3.523; *P<0.001*) indicating that H$_2$ is accepted.

Also materiality assessment construct has a significant positive and direct impact on efficiency of Islamic banks performance (β =0.102, *C.R* = 2.895; *P<0.01*) indicating that H$_3$ is accepted.

And sampling construct has a significant positive and direct impact on efficiency of Islamic banks performance (β =0.087, *C.R* = 2.042; *P<0.05*) indicating that H$_4$ is accepted.

But, internal control - assessment construct has an insignificant positive and direct impact on efficiency of Islamic banks performance (β =0.010, *C.R* = 0.185; *P>0.05*) indicating that H$_5$ is unaccepted.

While, internal controls-testing construct has a significant positive and direct impact on efficiency of Islamic banks performance (β =0.255, *C.R* = 4.305; *P<0.001*) indicating that H$_6$ is accepted.

And evaluation of observations and Shari'ah non-compliances construct has a significant positive and direct impact on efficiency of Islamic banks performance (β =0.238, *C.R* = 2.819; *P<0.01*) indicating that H$_7$ is accepted.

Similarly, using the work of relevant internal functions construct has a significant positive and direct impact on efficiency of Islamic banks performance (β =0.207, *C.R* = 3.469; *P<0.001*) indicating that H$_8$ is accepted.

Table 3. Hypotheses testing result

Hypotheses	Estimate	S.E.	C.R.	P-Value	Result
H$_1$	0.323	0.075	4.337	***	Supported
H$_2$	0.188	0.053	3.523	***	Supported
H$_3$	0.102	0.035	2.895	0.004	Supported
H$_4$	0.087	0.043	2.042	0.041	Supported
H$_5$	0.010	0.054	0.185	0.853	Not Supported
H$_6$	0.255	0.059	4.305	***	Supported
H$_7$	0.238	0.085	2.819	0.005	Supported
H$_8$	0.207	0.060	3.469	***	Supported

Note. *** indicate a highly significant at < 0.001.

6. Discussion of Findings

Model modification for this study was necessary, since the structural equation model fit indices has not been satisfactory. From perspective of auditors and employees in Islamic banks, this suggests effect of external Shariah audit on efficiency of Islamic banks performance. These imply that was role of planning, risk assessment, materiality assessment, sampling, internal controls - testing, evaluation of observations and Shari'ah non-compliances, using the work of relevant internal functions leads to better efficiency performance in Islamic banks, except in the case of Internal Control - assessment not show this role.

7. Conclusion and Future Research

This study has revealed that external Shari'ah audit significantly affect the efficiency of Islamic banks performance. We also found that, seven construct significantly affect the Islamic banks performance, but not in one case it is recommended to include a mediating variable such as corporate governance or ownership structure to explain the other variables. In this study did not include at study sample any mediating variable as corporate governance or ownership as feature to insight of the indirect relationship.

Results of this study will be useful for the external and internal auditors for Islamic banks performance development through enhancement of method Shari'ah audit in the Islamic banking sector.

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