

EXPLORING SHARIAH GOVERNANCE FACTORS IN
INTERNAL SHARIAH AUDIT EFFECTIVENESS: CASE
STUDY OF SELECTED ISLAMIC BANKS IN YEMEN

BY

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ABSTRACT

Internal Shariah audit in Yemen, which is neither centralised nor governed by the Central bank of Yemen (CBY), had caused the adoption of different standards and guidelines as well as policies and practices by Islamic banks. Previous studies found gaps in the banks' internal audit, such as Expectation-Performance Gap, Deficient Performance Gap and Deficient Standards Gap. This study examined the effectiveness of internal Shariah audit in Islamic Banks in Yemen by exploring the mutual relationship between the internal Shariah audit and key elements and principles as factors of Shariah governance based on the Institutional Theory. The Institutional Theory discusses the organisation's normative pressure, coercive pressure, and mimetic pressures arising from the surrounding environment affecting and interacting with the Islamic bank. This research aims to examine their direct impact on internal audit effectiveness regarding SSB, internal Shariah audit mechanism, internal Shariah auditor requirements and, finally, internal Shariah audit practices. In addition, the research aims to assess the current Islamic Bank internal Shariah audit policies and practices adoption of external regulatory requirements and best practices. The third objective is to assess the coherence of the internal Shariah audit framework and effectiveness in Islamic banks based in Yemen to enable internal Shariah audit effectiveness. The primary analysis technique is the pattern matching technique of documented policies and procedures and interview findings for comparing predicted patterns with ones that have been empirically observed and identifying any variance of gaps. The study found the lack of coordination and harmony between external and internal regulatory perspectives on internal Shariah audit requirements as well as the lack of similarity of standardization across Islamic Banks are indicative of lack of coherence of internal audit effectiveness within a self (institution) governance rather than an external governance system. It presents an insightful, unique finding that may affect coherent, consistent, and comparable internal Shariah audit effectiveness development among Islamic banks in Yemen. This study concluded that Institutional Theory is relevant to describe and distinguish the pressures exhibited by the Islamic bank of Yemen and Saba Islamic bank. An importance and uniqueness of this study is that both pertinent external and internal factors related to internal Shariah audit effectiveness are evaluated. This is because analysing only one or a few factors in evaluating any function effectiveness in prior studies may not lead to reliable results. In addition, using primary data along with interviewing key staff in both banks strengthen the findings to be useful as policy guidance for regulators and for future research.

خلاصة البحث

أدى التدقيق الشرعي الداخلي في اليمن، والذي لا يخضع للمركزية ولا يحكمه البنك المركزي اليمني، إلى اعتماد معايير وإرشادات مختلفة وكذلك سياسات وممارسات من قبل البنوك الإسلامية. وجدت الدراسات السابقة ثغرات في التدقيق الداخلي للبنوك، مثل فجوة التوقعات والأداء، وفجوة الأداء الضعيف، وفجوة المعايير المعيبة. تناولت هذه الدراسة فاعلية التدقيق الشرعي الداخلي في البنوك الإسلامية في اليمن من خلال استكشاف العلاقة المتبادلة بين التدقيق الشرعي الداخلي والعناصر والمبادئ الأساسية كعوامل للحوكمة الشرعية على أساس النظرية المؤسسية. تناقش النظرية المؤسسية الضغط المعياري للمؤسسة، والضغط القسري، والضغوط المحاكية الناشئة عن البيئة المحيطة التي تؤثر على البنك الإسلامي وتتفاعل معه. يهدف هذا البحث إلى: أولاً، التعرف على العديد من عوامل الحوكمة المتعلقة بالتدقيق الشرعي الداخلي، والتي يفحص تأثيرها المباشر على فاعلية التدقيق الداخلي فيما يتعلق بمعايير الرقابة الشرعية، وآلية التدقيق الشرعي الداخلي، ومتطلبات المدقق الشرعي الداخلي، وأخيراً ممارسات التدقيق الشرعي الداخلي. ثانياً، تقييم سياسات وممارسات التدقيق الشرعي الداخلي الحالية للبنك الإسلامي، واعتماد المتطلبات التنظيمية الخارجية وأفضل الممارسات. ثالثاً، تقييم مدى تماسك إطار التدقيق الشرعي الداخلي وفاعليته في البنوك الإسلامية الموجودة في اليمن لتمكين التدقيق الشرعي الداخلي. اعتمد أسلوب التحليل الأساسي على أسلوب مطابقة الأنماط للسياسات والإجراءات الموثقة ونتائج المقابلات لمقارنة الأنماط المتوقعة مع الأنماط التي تمت ملاحظتها تجريبياً وتحديد أي تباين في الفجوات. توصلت الدراسة إلى أن عدم وجود تنسيق وانسجام بين جهات النظر التنظيمية الخارجية والداخلية بشأن متطلبات التدقيق الشرعي الداخلي، فضلاً عن عدم وجود تشابه في التوحيد بين البنوك الإسلامية، يدل على عدم تماسك فاعلية التدقيق الداخلي في إطار الحوكمة الذاتية بدلاً من أن يكون نظام حوكمة خارجي. يقدم البحث نتيجة ثاقبة وفريدة من نوعها قد تؤثر على تطوير فاعلية التدقيق الشرعي الداخلي المتماسك والمتسق والقابل للمقارنة بين البنوك الإسلامية في اليمن. خلص البحث إلى أن النظرية المؤسسية ملائمة لوصف وتمييز الضغوط التي يبديها البنك الإسلامي اليمني وبنك سبأ الإسلامي. تكمن أهمية البحث بتفرده في تقييم كل من العوامل الخارجية والداخلية ذات الصلة المتعلقة بفاعلية التدقيق الشرعي الداخلي. وذلك لأن تحليل عامل واحد فقط أو عدد قليل من العوامل في تقييم فاعلية أي وظيفة في الدراسات السابقة قد لا يؤدي إلى نتائج موثوقة. بالإضافة إلى أن استخدام البيانات الأولية جنباً إلى جنب مع إجراء مقابلات مع الموظفين الرئيسيين في كلا البنكين يعزز النتائج لتكون مفيدة كإرشاد للسياسات للمنظمين وللابحاث المستقبلية.

APPROVAL PAGE

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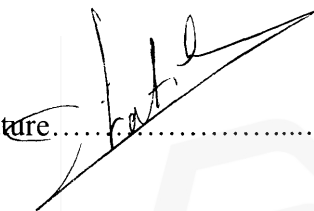
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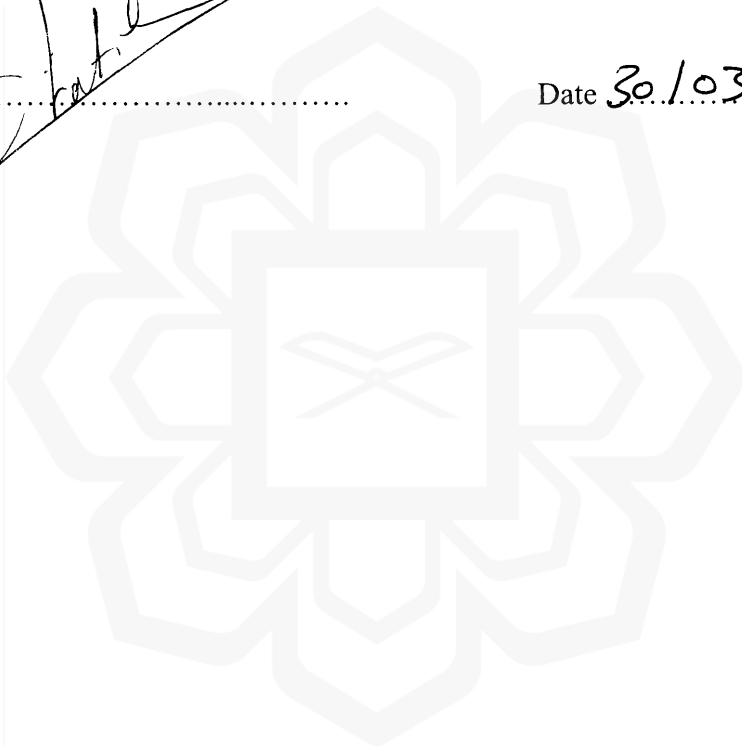
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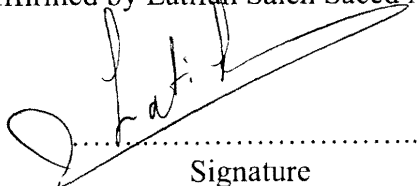
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This thesis is dedicated to my beloved father Saleh Saeed Munassr, my mother Safiah Ahmed , my sisters and brothers especially my dear sister Muneera , with whom I always find love and courage.

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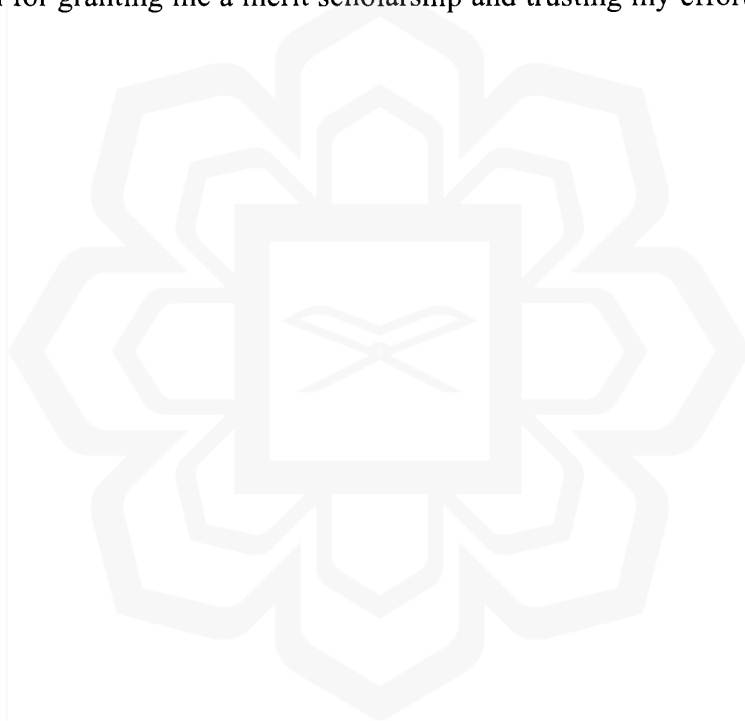


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LIST OF ABBREVIATIONS

ASIFI	Auditing Standard for Islamic Financial Institutions
AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
AIU	Audit Inspection Unit
BOD	Board of Directors
BNM	Bank Negara Malaysia
CBY	Central Bank of Yemen
GCC	Gulf Cooperation Council
IRTI	Islamic Research and Training Institute
IAH	Investment Account Holders
IFSB	Islamic Financial Services Board
IDB	Islamic Development Bank
ISB	Islamic Saba Bank
IBY	Islamic Banks of Yemen
ICG	Islamic Corporate Governance
IIFM	International Islamic Financial Market
ISA	International Standards of Audit
IFAC	International Federation of Accountants
IES	International Education Standard
IIA	Institute of Internal Auditor Research Foundation
IFAC	International Federation of Accountants
LMC	Liquidity Management Centre
MIA	Malaysian Institute of Accounting
NYSE	The New York Stock Exchange
NDA	Non-Disclosure Agreement

OECD	Organisation for Economic Co-operation and Development
SB	Shariah Supervisory Board
SG	Shariah Governance
PBUH	Peace Be Upon Him



CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

According to the Global Islamic Finance Markets Report (2019), significant capital market growth is recorded with Sukuk and Islamic bonds issues for the growing Halal Sector. Also, the World Islamic Banking Competitiveness Report (2013) stated that Islamic banking is developing at a 50% growth rate faster than conventional banks (David McLean, 2013). It was also reported that Islamic banking assets have reached 55% in the top 20 Islamic banks and exist mainly in Malaysia, Gulf countries, and Turkey. Commercial banks in Yemen are moving into the Islamic banking sector due to the remarkable success of the four Islamic banks in Yemen. These include Saba Islamic bank, Tadamon International Islamic, Islamic banks of Yemen for Finance and Investment, and Shamil Bank of Yemen and Bahrain (Yemen Fox News, 2012).

The Islamic banks in Yemen are subject to different regulations and variations of practices due to not being centralised and governed by the Central bank of Yemen (CBY). This is observed in the adoption and implementation of governance policies and mechanisms and consequent effectiveness of internal Shariah audit in each bank. This research explores the governance factors and assesses the effectiveness of internal Shariah auditing of two selected Islamic banks in Yemen: Saba Islamic bank and Islamic banks of Yemen for Finance and Investment. The need for internal auditing from prior literature was highlighted and established based on institutional theory (Mihret, 2010; DiMaggio & Powell, 1983, Arena & Azzone, 2007; Colicchia, Melacini & Perotti, 2011) that identify the factors leading to the need for effective internal

auditing. In terms of the necessity of Shariah auditing, some prior studies related to the practice of Hisbah (Cook, 2000; Hasan, 2008; Elsergany, 2010; Alserhan, 2011) by the Prophet Muhammad (PBUH) which laid the foundation of Shariah audit principles.

Furthermore, the potential Shariah non-compliance risks of Islamic banks were also highlighted, including the role of internal Shariah auditing within the Shariah governance framework, in which the audit is executed. Different country settings are examined to illustrate the reasons for patronising Islamic banks. The need for qualified Shariah auditors is discussed, along with whether Shariah auditors' requirements should be met. This is followed by an overview of Islamic banks in Yemen, including exploring current Shariah audit policy, practices, and standards. In terms of coherent Internal Shariah Audit Framework, this study attempts to articulate the factors affecting the effectiveness of internal Shariah audit of both Islamic banks.

1.2 THE IMPORTANCE OF SHARIAH AUDITING

All Islamic financial institutions must apply the Shariah rulings to ensure proper and appropriate monetary transactions and investments as be a practical part of the Islamic economy. Adequate and effective adoption of Shariah rulings based on previous studies emphasised the importance of internal Shariah auditing in Islamic banks. These include the fulfilment of the Maqasid Shariah, avoidance of the possible Shariah non-compliance risks, and the gain that stakeholders trust through establishing strong Shariah governance, which requires internal control tools like the Shariah audit.

The economic system in Islam is an integral part of Islamic jurisprudence that covers the religious, social, political, and ethical aspects of human life. As a result, Shariah auditing plays a vital role by assuring to achieve the said objectives and fulfil the Maqasid Shariah (Ibrahim & Yaya, 2005). Islamic banks must enhance their Shariah

audit framework and ensure that all transactions and the products offered in Islamic banks are Shariah-compliant (Umer & Habib, 2002). Due to the success and growth of Islamic banking and finance, Islamic banks are held responsible for being in line with Shariah principles in all their activities, leading to the proper development of Shariah auditing (Ibrahim, 2008). Ibrahim (2008) added that Shariah auditing does not reject all the techniques and mechanisms of conventional auditing. They can be used to test the values in line with Shariah.

Furthermore, Khan (1985) stated that auditing techniques gained from conventional auditing in the financial sector are relevant to the socio-economic infrastructure and the culture of Islamic society. The objectives of internal Shariah auditing are the same as those in the conventional financial audit; however, the differences emerge based on the Auditing Standard for Islamic Financial Institutions (ASIFI No.1). It mentions that Shariah auditing assures that Islamic banks' transactions follow Shariah principles and rules, specified by Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) standards, and local and national accounting standards.

Internal Shariah auditing provides a certain level of assurance to stakeholders on Shariah governance. However, prior studies highlighted consistency in Shariah pronouncements by various SSB, lack of professional competence in both financial and Shariah skills, and independence from other party's influences (Kasim et al., 2013). Reliance on conventional accounting and auditing are inappropriate and insufficient as it is confined to financial materialistic values not relevant to and not inclusive of Maqasid Shariah (IRTI 15th DL Course). Due to the main objective of Islam, it is not only about maximising legitimate profits, but to protect and benefit the people on their affairs in this life and the hereafter (Laldin, 2011). Therefore, conventional audit focuses

mainly on the financial statement to present an accurate and fair view to investors (Eilifsen et al., 2006). This makes it insufficient to meet the objectives of Maqasid Shariah, and therefore, not suitable as an audit framework for Islamic banks (Ibrahim Yaya, 2005).

On the other hand, gaining the confidence of stakeholders is the main target of any business; therefore, business growth and stability depend on the trust of the stakeholders (Mayer,1996). What is meant by the trust of stakeholders in Islamic institutions is running the business with a high degree of professionalism in management based on religious beliefs according to the fiduciary relationship (Grais and Pallegriani, 2006). Therefore, if the Shariah aspect is weak or absent in the services and products being offered in Islamic banks, it will lead to a severe undermining of the trust toward the institutions, resulting in Shariah non-compliance risk (Bhambra, 2007).

Table 1.1 highlights the differences between conventional and Shariah auditing and explain why conventional auditing is not adequate for Islamic banks.

Table 1.1: Comparison between Conventional and Shariah Auditing

	Conventional auditing	Shariah auditing
Definition	“Internal auditing is an independent, objective assurance, and consulting activity” (Institute of Internal Auditors (IIA, 1999).	“Shariah audit is the examination of an Islamic banks compliance with the Shariah, in all of its activities” (Hanif, 2010; Sultan, 2007).
Objective	“To add value and improve an organisation operation” (IIA, 1999)	Shariah's audit objective is to ensure that Islamic banks' operations and transactions follow Shariah principles (AAOIFI GSIFI No. 2).
Scope	Auditors focus on critically assessing the financial	Ensure that all activities are within the Shariah. This

	statement (Flesher, 1996; Brink, 1991; Eilifsen et al., 2010).	examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, and reports (Hanif, 2010; Sultan, 2007).
Auditor Skills and Qualifications Required	Moral, academic, and professional knowledge qualification (Uddin et al., 2013)	Academic, professional, and Islamic knowledge (Rahman, 2011; Kasim, Ibrahim & Sulaiman, 2009)
Disclosures and Reports	Limited information disclosures that concern the public only and the report usually present economic matters (Uddin et al., 2013)	Full disclosures of information that concerns all stakeholders considering the economic and social matters based on Islamic ethical value (Sadeghzadeh, 1995; Tapanjeh, 2009, Bhatti and Bhatti, 2010)
Orientation	It is always organisation and investor-oriented (Uddin et al., 2013)	It is oriented to the public and society (Khan, 1985).

Based on previous literature (Wilson, 2011; Hamza, 2013; Hasan Z., 2010), Shariah governance can be described based on three approaches: the centralised approach, the *laissez faire* approach, and the hybrid approach. The centralised or the *proactive approach* is practiced in Malaysia and Pakistan. Shariah compliance is assured by the government, represented by the National Shariah Authority in Malaysia, and Shariah Board (SB) in the central bank that guides the central bank on Shariah matters (BNM,2019). Shariah compliance using this approach is implemented at the institutional level as well by internal SSB. The guideline and the Shariah audit guidelines are set by the central bank, which imposes on Islamic banks the Shariah audit policy. Furthermore, the certification for Shariah auditors may be initiated by the regulatory agency and/or the Islamic finance industry.

The laissez-faire approach is followed in some Gulf countries where there is no intervention from the government. It is more self-regulated like the approach adopted in Saudi Arabia and Oman, also called the passive model or approach (Hamza, 2013). There is usually no policy and set guidelines for Shariah audit. As such, it becomes an optional reputational matter with no requirement for Shariah auditor certification.

The third model is the hybrid model, where the institutions are self-initiated but are required to disclose their efforts to ensure Shariah compliance with the regulating authority (Hasan Z., 2010). In this model, the Shariah audit guideline and policies are issued by the central regulatory authorities. A certificate of Shariah audit is usually issued by the industry, such as in the UAE.

A comparative study that analyses the Shariah supervisory model in Southeast Asia and GCC concludes that the critical pillars for a robust system that can establish a strong Shariah governance system are: effective Shariah authorities, Shariah framework, and effective international and national Islamic financial organisations (Grassa, 2013). Since the main objective of this research discusses Shariah auditing, there is a need to explain Shariah auditing because Shariah auditing is one of the fundamental pillars of Shariah governance (BNM, 2011). According to Umer & Habib (2002), it is not logical to assume that Islamic banks do not need Shariah governance because the Islamic ethics and values are enough to protect the stakeholders' interests. On the contrary, Shariah governance works as a system in which the rights and responsibilities of the stakeholders are organised for controlling and directing purposes as well as for the procedures and rules to ease the process of making decisions and make them more effective (Ahmad, J.S. 2010). Internal auditing and corporate governance have become a prominent public policy discussion due to the increased demand for accountability and transparency in the internal control system (Zou, 2019; Sarens et al.,

2012; Al-Jabali et al., 2011; Maijoor, 2000). However, corporate governance cannot be applied entirely in Islamic banks due to differences between the two models, as shown in Table 1.2.

Table 1.2: Comparison between Shariah and Corporate Governance

	Corporate Governance	Shariah Governance	Sources
Objectives	Maximise the profits of shareholders or maximise the wealth of shareholders	Maximise the profits of shareholders and serve the people interest within Allah orders	Elahi et al., 2011; Laldin, 2011
Internal Governance Players	Board of Directors	Board of Directors and Shariah Committee	Wardhany & Arshad, 2012; Nienhaus, 2007
Stakeholders and Their Relationships (Governance Structure)	Investors' money is guaranteed. As a result, they are not considered shareholders.	Inventors' money is not guaranteed, e.g. (Investment Account Holders IAH)	Abu Zaid, 2002
Types of Contracts	Based on Legal implications.	Based on both Legal and Shariah implications.	Umer & Habib, 2002
Means to Control the Performance	Internal control, external audit, accounting, and risk management	Internal control, external audit, accounting, risk management, and Shariah audit and Shariah review	(Lewis, 2005)
Risk Management	Risk Management Division (credit, market and operational risk)	Risk Management Division and Shariah Compliance Risks Management	(Umer & Habib, 2002)

The nature of risks in Islamic banks differs from conventional financial institutions, making the Shariah audit very important. It is considered one of the tools