

# The Effectiveness of Internal Audit Function in Non-Profit Organization

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## ABSTRACT

This study to explore the implementation and function of internal audit department in four selected zakat institutions in Malaysia. The main objective of this study is to see whether the internal audit function in these organization has access to resources needed, power and authority, and appropriate support from management, so that it will be able to function effectively. Since zakat institutions plays an important role in Malaysian economics, it seems very crucial for it to maintain highly governance practices in its organization. Thus, effective internal audit function is one of key important elements to be focused in order to achieve good governance practices. Each zakat institution was represented by chief auditor and internal auditors. There are four factors explored, namely organizational status, scope of function, management support and competency of auditors. Based on the findings, it can be concluded that internal audit function in selected zakat institutions has appropriate organizational status, scope of functions, management support and competent in performing the internal audit work. With all respondents clearly indicate that management support are the most important factors for internal audit function to be effective, followed by established internal audit procedures, training, as well as good cooperation by the auditee. However, there are areas still need to put focus on, which include lack of staffs, especially staff with auditing background, less focus on financial audit and independence structure of the internal audit function.

*Keywords: Internal audit, Internal audit effectiveness, Zakat governance, Competency.*

## INTRODUCTION

Internal audit has become a crucial function within organisations due to the recent spate of corporate collapses and financial scandals (Schneider, 2003; Arena et al., 2006). These events made internal audit as one of the contributing factors towards good corporate governance, and has strongly influenced on the adoption and practice of the internal audit. The effectiveness is a key issue for those interested in internal audit such as internal auditors themselves or its main customers, namely: (1) the board and the audit committee, to whom internal audit reports, (2) senior management, who should be sure that internal audit activities cover the principal business risks, and (3) external auditors, who have a direct interest in the work of internal audit (Brilliant et al., 1997; Mihret et al., 2010; Lenz and Hahn, 2015).

Zakat is one of the pillars Islam which has been made obligatory by Allah s.w.t to each and every Muslim. Zakat means taking some particular property, according to the specific characteristics and to be given to certain beneficiary groups or Asnaf (Al-Maward, 2011). Zakat, as a financial distribution can be used to reduce poverty and improve their

quality of life, whereby the property can be distributed to eligible individuals (Aida et.al, 2012).

Zakat institutions face big challenges as the result from loss of public confidence. Something needs to be done to clean their tarnished image and reputation. The study about zakat institutions governance could provide inputs in making zakat institutions more competitive and organized as the inputs will help zakat institutions in measuring their performance and would indicate which aspect should be given more attention.

This scenario reflects the reputation of the zakat institution in the eyes of the public. Internally, the institution needs to improve their performance from time to time in order to cover the bad perception of the public on their management. One of the ways to keep the management and good governance on track is by having auditing process gradually. Due to this reason, some zakat institutions have their own internal audit department in order to improve their administration and management.

## **LITERATURE REVIEW**

### **Zakat Institutions**

Zakat institutions are expected to play a key role in promoting the socio-economic objectives of *zakat* in Malaysia. Thus, it is of prime importance that these institutions are being managed effectively and efficiently. Being public service organisations which are accountable to the stakeholders and Muslim public at large, these *zakat* institutions have been subjected to intense public scrutiny and criticism. cursory examination would indicate many parties questioning the efficiency and effectiveness of these institutions in managing *zakat* affairs of their respective states.

The effectiveness of zakat institutions is important to enable zakat to be a catalyst in improving the lives of the poor and needy (Mahyuddin & Abdullah 2011). For the zakat institutions to be effective, one of the main components is by applying the corporate governance (CG). Corporate Governance can be defined as the process and structure used to direct and manages the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking account to the interest of other stakeholders', corporate governance (2002). This shows that the corporate governance not only affects the shareholder but also affects the other stakeholders. Then, a revised version of Malaysian Code on Corporate Governance (MCCG, 2007) introduced with the objective of strengthen the roles and responsibility of the board of directors, audit committee and the internal audit function (Ramachandra and Rathish, 2017).

### **Roles of Internal Audit in Zakat Institutions**

Effective implementation aspects of Good Corporate Governance (GCG) in zakat institutions will be able to assist management in conducting internal supervision of the company to be more effective and efficient. One of the important tasks of Internal Audit (IA) in the implementation of GCG is to investigate and assess the internal control and efficiency of the company's operational implementation independently (Wulan, 2012). Currently, the role of IA has shifted in practice. Initially, IA functions as watchdog,

consultant, and catalyst (Wulan, 2012). Now, internal Audit's function is expanded to improve and add value for entity's operation (Vallabhaneni, 2014). This function supports the IA' role defined by IIA which contains assurance and consulting roles. In General, the scope of internal audit (and, therefore, the scope of the assurance given) should go beyond compliance with processes and should also go beyond the adequacy of the processes themselves of governance, risk management and internal control. Internal audit has a duty to consider also the quality of the inputs to, and the outputs from these processes, and to identify and report any unacceptable levels of risk (Chambers, 2015).

On the other hand, one of the objectives of Malaysian Code on Corporate Governance (MCCG, 2007) is strengthen the role and responsibility of audit committee. The audit committee playing a monitoring role for the true and fairness of the financial statements as well as the effectiveness of organization's control system. The audit committee are the involvement of the internal audit of the organization. Therefore, the internal audit effectiveness may affect the effectiveness of audit committee. As mentioned by (Bostan and Grasu, 2010) role of internal audit in company is considered important in the corporate governance field. Dittenhofer,2001 also mentioned that the effectiveness of internal audit greatly contributes to the effectiveness of each auditee and the organization at large.

There are many key factors that leads to the effectiveness of internal audit. One of the factors are the competency of the auditor. Auditor competency is the ability of an auditor to apply the knowledge and experience that have been possessed in auditing, so that the auditor can perform audit carefully, accurately and objectively (Carolita and Rahardjo, 2012). The higher the auditor competency, the higher the effectiveness of internal audit (Sukriah et al, 2009). Therefore, the auditor competency is of the important role for the internal audit become effectively. Thus, with the effectiveness of internal audit will make the organization or zakat institution to performance efficiently and effectively.

Thus, this research would try to identify the position of internal audit function in four selected zakat institutions in Malaysia. The aim is to investigate whether the internal audit is functioned effectively in order for them to be able to play the role as a risk assessor, controller and gate keeper to any potential harm that may jeopardize the credibility of zakat institutions.

## **RESEARCH METHODOLOGY**

The research design for this study is partly based on the theoretical framework which was the combinations of Agency Theory and Institutional Theory. It aims to establish the relationship between factors which are associated to Zakat Institutions performance. As far as time horizon is considered, this study can be considered among cross-sectional studies because the data are gathered just once, but over a period of almost four months starting from mid Feb and lasting until May 2010. Sekaran (2003, p.135) calls this type of studies as one-shut or cross-sectional studies. In what follows, the detailed analysis of the research design is presented. Generally, this research was conducted using qualitative method (face to face interview).

The semi-structured interview questions has been conducted with all the representatives of four zakat institutions namely; PZ1, PZ2, PZ3 and PZ4. For every zakat institution, two interview sessions were conducted; one with the Chief Audit Executive (CAE) and the Internal Auditors (IA) and the other with the auditees. The auditees were represented by two auditees from different departments.

There are four factors explored, namely organizational status, scope of function, management support and competency of auditors. These the independent variables are constructed from guidelines on the international standards for the Professional Practice of Internal Auditing (ISPPIA) published by the international institution for internal audit Malaysia (IIA), 2016 and measured toward Zakat institution's performance.

## RESULTS AND DISCUSSIONS

### Demographic Results

Table 1 shows the analysis of respondent background of the study.

**Table 1: Respondents Background**

	Frequency	Percentage (%)
<b>Gender</b>		
Men	52	55.3
Women	42	44.7
<b>Age</b>		
21-30	10	10.6
31-40	36	38.3
41-50	41	43.6
51-60	7	7.4
<b>Working Experience</b>		
Less than 2 years	1	1.1
2-5 years	8	8.5
5-10 years	27	28.7
10 years and above	58	61.7
<b>Academic Background</b>		
SPM/STPM/Sijil	9	9.6
Diploma	13	13.8
Bachelor's Degree	33	35.1
Professional Certificate	2	2.1
Master/PhD	37	39.4
<b>Department</b>		
Accounting	16	17.0
Finance	5	5.3
Business Management	57	60.6
Computer/IT	10	10.6
Engineering	6	6.4
<b>Position</b>		
Internal Auditor	60	63.8
Quality Auditor	17	18.1
Others	17	18.1
<b>Professional Member</b>		
Accounting	7	7.4
Internal Auditor	26	27.7
Finance/Islamic Finance	17	18.1
IT	2	2.1
Others	42	44.7
<b>Total</b>	<b>94</b>	<b>100</b>

## **Main Results**

Research objective of this research is to investigate the effectiveness of internal audit function in zakat institution. The following table 2 presents the results by reviewing the transcription analysis of PZ1, PZ2, PZ3 and PZ4 based on the variables namely organizational status, scope of work, management support and competency of the internal audit function.

### **a. Organizational Status**

Generally, all internal audit departments in the selected zakat institutions actively play their roles as internal auditors. Their existence was signified by the management as well as the institution as a whole. They were given specific job functions, power and authority needed. Three out of the four internal audit departments report directly to the management. However, in certain circumstances they also have access to audit committee or board of directors in which normally been approved first by the management. Only one internal audit department has a total independence to communicate with the audit committee without any interference from the management.

Since the zakat institutions have very unique function in society as a non-profit organization, thus the internal audit department's works focus more on the accountability and quality of collecting and distributing process of the zakat money. The yearly audit plan is developed based on operational activities of these functions. By having this, they believe that they would be able to increase public confidence towards zakat institutions as a whole. It is also can be concluded that the internal audit departments in zakat institutions do not focus on auditing financial reports. For instance, one zakat institution was found to completely not conducting financial audit because the function has been outsourced by the management. Only one institution did mention that they review compliance on accounting standards in the Finance Department. Another two institutions revealed that they conduct financial audit but more on operation and compliance to their standard operating procedure (SOP).

### **b. Scope of Function**

The internal audit department significantly involves in monitoring control functions and governance structure of the zakat institution. Through the audit process they are able to monitor the compliance towards the standard operating procedure developed and provide suggestions for improvement. They also review the relevancy of the rules and procedures periodically. In certain institution, the functions of the internal audit are extended to risk assessment. The yearly audit plan was developed based on risk assessment done in each department. In addition, there is specific risk management department which responsible to assess and manages the risk with risk assessor representative in each department to assist this organization in profiling the potential risk. This department is put as subdivision of the internal audit department and they are continuously coordinating their work throughout the year.

Each internal audit department approached is given power and authority to access any evidence needed without any restriction from any party. Generally, auditees are able to give good cooperation at most of the time. However, the way the auditee responses would depend on the approach being used. In other words, the internal auditor needs to have high level of professionalism, ethical value and good communication and manipulating skill.

Other than that, in order to get good support from auditee, the internal audit department also need to proof that they are really significant in the organization.

#### **c. Management Support**

In addition, all selected zakat institutions agreed that they received full support from management in term of budgets, staffs, convenience workplace and training. Management also provides support through appropriate reaction towards audit report and initiate improvement action at every level.

#### **d. Competency**

Which regards to competency, the results are varied because there is zakat institution which emphasizes educational background and another zakat institution looking at skills and experience as the basis for the appointment of internal audit department staff. In terms of audit work, in general, all zakat institutions have annual audit plans for their organizations. They conduct compliance and operational audit and specifically did surprise audit and forensic audit when necessary. Then, most of the zakat institutions did not have sufficient number of staffs under their internal audit department. There is one zakat institution moving forward to have a computerized audit tools and techniques as compared to others which only used information technology as a monitoring tool.

### **CONCLUSION**

In conclusion, all respondents agreed that the auditors are qualified, knowledgeable, competent and experienced in conducting audit tasks. Most of auditees believe that the auditors are skillful due to broad experience and well trained in conducting audit task. In fact, they are considered efficient in performing their audit functions as a result of their experienced, well trained and well-versed with the policies and procedure set by internal audit department. All respondents agreed that internal audit department performs their functions ethically and respects the rightness of auditees throughout the audit process. That is why they are credible in the eyes of the auditee.

On the other hand, any non-compliance, misstatement and weaknesses in the work process reported by the auditors will significantly affect the department efficiency and effectiveness. That is why all the respondents will just follow the suggestions for improvement by the auditor. They agreed that any positive critics, any advice and recommendation will be well accepted by the auditees. Such recommendation and suggestions for improvement by the auditors are taken into action and will be applied where necessary.

Meanwhile based on the qualitative data testing, it is found that all independent variables (organizational status, scope of work, management supports and competency) correlate positively and significantly with the zakat performance. It means that, the organizational status, scope of work, management supports and competency of the internal auditors are significantly related with the performance of zakat institutions. Results from the multiple regression analysis concludes that only organizational status and competency were act as significant predictor for the zakat performance. Organizational status seems to be the strongest unique contribution to explaining the zakat performance, followed by the competency of internal auditors.

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