

# **The Effect of Audit Committee Role and Internal Auditor Role on Internal Control Effectiveness at Islamic Bank in Indonesia**

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## **Abstract**

This research examines the effect of audit committee role and internal auditor role on internal control effectiveness. The data is provided from many Islamic banks in Indonesia that was taken by questionnaire from 72 respondents. Questionnaire is consisted of 27 questions. Research instrument contains 9 questions about audit committee role, 8 questions about internal auditor role, and 10 questions on internal control effectiveness. Data analysis used multiple regressions. The result of this research showed that audit committee role and internal auditor role influenced internal control effectiveness simultaneously. Partially, audit committee not significant, but internal auditor influenced internal control effectiveness.

Keywords: audit committee role, internal auditor role, internal control effectiveness, Islamic bank

## **I. Introduction**

Rapid development lately of Islamic banking activity driven by the existence of the office channeling, where conventional banks are able to serve its customers sharia in conventional branches (so no need to open a new branch office that requires large investments). These developments demand the immediate implementation of GCG practices in the management of banks in order to provide maximum protection to all parties interested in stakeholders, especially customers or depositors. Besides, the implementation of GCG can help minimize the Islamic bank financing is not good quality, improve the accuracy of assessment of banks, infrastructure, quality of business decision-making, and have a system for early detection of high risk areas of business, products, and services (Chapra & Ahmed, 2002).

**Tabel 1. The Islamic Banking Cases in Indonesia Related to Internal Control Problem**

Year, Bank's Name	Cronological
2002, BSM & BNI Syariah (UUS)	Bank Syariah Mandiri (BSM) and BNI (Sharia Unit) joint in syndication financing to Indosat Multimedia Mobil (IM3) project and got interest for that financing 19% pa. Islamic Bank may not use Interest concept, so the revenue of this financing could not be reported in to income statement.

2011, BRI Syariah	Case of granting credit fictitious Attack BRI Syariah Rp 212 billion involving 5 people. Deni Kurniawan demanded two years in prison and a fine of Rp 50 million. Amir Abdullah criminal defendant sentenced to 6 years in prison. The defendant Muhammad Sugirus, sentenced to 4 years in prison. Both defendants also imposed fines amounting to Rp 150 million, a subsidiary of three months confinement. They are also required to pay compensation of Rp 79.4 billion to be paid one month after the verdict. Wijaya Dedih defendant sentenced to 4 years. While Asry Ulya sentenced to 6 years in prison, together with his demands. They are engaged in loan application engineered and without verification, BRI disbursed Rp 212 billion.
2012, Bank Jateng	Defrauding Bank of Central Java with tekdakwa Yanuelva Etliana. Mode is used in question is to ask tens of fictitious work orders from several government agencies submitted that the accused, to obtain credit in the Bank of Central Java by conventional Rp14,2 billion, and Bank Syariah Unit Semarang Central Java Rp29 billion. The defendant also gave money amounting to Rp250 million to the former Head of the Regional Disaster Management Agency (BPBDs) Java Priyanto Jarot Nugroho has also been declared as a suspect and is undergoing the same process of the trial cases.
2013, Bank Syariah Mandiri	Developer (Iyan) applying for a loan amounting to Rp1 billion to BSM Bogor. Iyan and three employees of BSM Bogor then create fake customers for facilities eligible for mortgage financing. They manipulate a number of documents, such as land certificate, ID card, and so on, and did not undergo the procedure that should be in the filed of banking credit. Three employees of BSM Bogor also receive a gift from the debtor Rp3-4 billion in cash, and no one received a car.
2013, BRI Syariah	Since 2010, Butet interested in the promotion of investment products such as gold pawn sharia. According to the lawsuit, the product was in the form of gold investment gold pawn Islamic products offered by the loan contract funds (qardh) and leasing (ijara). The customer signed a pledge certificate sharia (SGS) with a period of 120 days. The contract may also be extended by making the back as from the signing of the contract agreement deed. However, in early 2012, when et al Butet want to extend the loan contract and lease, BRI Syariah rejected. BRI Syariah even asked Butet et al sell gold that has been pledged by reason of a Bank Indonesia Circular Letter No. 14/7 / DPBS on gold-backed surveillance qardh products in Islamic banks and Islamic Business Unit. Plaintiff surprised and shocked with this circular. Because the product offered at the time of this pledge, BI has allowed marketing to the public and there is a safe guarantee of BRI Syariah. Butet has mortgaged 4.89 kg of gold, while M. Widodo 2.5 kg, 4 kg Hardianto TL, Beautiful Sulistyawati 9137 grams, Elsje Hartini 2 kg, 5 kg Sugiharto Robert and Selly Dull Goddess as much as 900 grams. Plaintiff BRI Syariah judge actions that forced selling of gold as collateral or the option to repay the loan

	<p>principal is very detrimental to the client. Butet loss reached USD 1.5 billion, while the total loss of six other customers Rp 11.2 billion. According to him, the sale without auction mechanism is contrary to Islamic principles and the principles of propriety. Butet cs confirms BRI Syariah have committed acts against the law because it does not provide true and honest about the condition and security of goods.</p>
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Source: Compiled from some various business news from 2002 – 2013.

Board commissioner in his capacity as a supervisor at the same operating company acts as a supervisor and consider the interests of stakeholders. With that role, the board was instrumental in implementing the principles of good corporate governance. To carry out its role as a supervisor, the board may engage the services of an independent professional advisor and / or forming a special committee. One of the special committee be formed board of commissioners is the audit committee. The Board of Commissioners shall establish an audit committee consisting of one or more independent board members. Commissioners may ask the company outside of the range of expertise, experience and other qualifications required, to sit as a member of the audit committee's role in order to achieve the objectives of the audit committee. The audit committee should be free from the influence of directors, external auditors, and thus only responsible to the board of commissioners (Komite Nasional Kebijakan Governance, 2002, 2006:15).

The audit committee serves to assess the internal auditor's examination program, the process and the work of the internal audit committee or investigation, supervise whether the directors have to take remedial action on recommendations made by the internal auditors (Ruin, 2003: 184). While Venkataraman, et.al (2013) stated:

*“The role of audit committee is to oversee the financial reporting process, internal control structure, and the management of risk of the company. In some countries, audit committee also oversee legal and ethical conduct of the company’s management and its employees.”*

Because leaders can not directly supervise the activities of the company, it must delegate some duties, powers and responsibilities and carried to another party. So that the necessary role of internal audit, internal audit as a free activity, which is prepared in the company. These activities examine and assess the effectiveness of the company. The existence of an internal audit is intended to improve the performance of the company (Tugiman, 1997:4).

Based on the phenomenon described above, it can be formulated central theme of this research, namely: Implementation of internal control requires the role of audit committees and internal auditors. Therefore, we need a study to empirically test the above conjecture under the caption "Audit Committee Role and Influence of Internal Auditors on Internal Control".

## **II. Theoretical Framework and Hypothesis Development**

### **II.1 Agency Cost**

The concept of corporate governance is essentially an extension of the concept of separation between owners and management companies in addressing agency problems. To overcome or reduce these agency problems will lead to agency costs (agency cost) which will be borne either by the principal or the agent. Jensen and Meckling (1976) agency cost is split into monitoring costs, bonding costs, and residual loss. Monitoring costs are costs incurred and borne by the principal to monitor the agent's behavior, which is to measure, observe, and control the behavior of the agent. Examples of these expenses are audit fees and costs to establish a compensation plan managers, budget restrictions, and rules of operation. While bonding is a cost incurred by the agency to establish and adhere to a mechanism that ensures that the agent will act for the benefit of the principal, for example, the costs incurred by the manager to provide financial reports to shareholders. Shareholders will only happen if the cost of bonding allow such costs can reduce the cost of monitoring. While the residual loss arising from the fact that agents sometimes act differently than the action that maximizes the interest of the principal. Audit committee and the internal auditor function well will create strong internal controls so that the agent will act for the benefit of the principal.

### **II. 2 Audit Committee**

The audit committee has now been recognized in almost all companies in developed countries, especially in the United States, Britain and Canada, but until now there has been no agreement on the measure of the success or effectiveness of the audit committee. There has been no empirical evidence regarding the outcome of the case, but Sommer (1991) in Manao (1997) argued that the audit committee in many companies are still not doing a good job. Sommer opinion, many audit committees are merely doing routine tasks, such as review reports and the selection of the external auditor, and not to question critically and analyze in depth the conditions of control and execution of responsibilities by management. The cause is suspected not only because many of them do not have adequate competence and independence, but also because many do not understand the role of principal.

Kalbers & Fogarty (1993) has conducted research on the factors that influence the effectiveness of the audit committee. Research results revealed that there are three dominant factors that influence the success of the audit committee in carrying out its duties, namely: formal and written authority for the audit committee, management cooperation, the quality (competence) personnel of the audit committee.

A important aspect in the success of the audit committee in carrying out its duties is a matter of communication. Therefore, the audit committee should improve communication with the board of commissioners, management, internal auditors and external auditors. The existence of smooth communication between the audit committee with the various parties can demonstrate the existence of

an audit committee is more effective and can ease the task of the commissioner in overseeing the company.

The existence of an audit committee currently has been accepted as a part of the organization's corporate governance is good (good corporate governance). In addition, the presence of an audit committee lately has received a positive response from various parties, including the Government, the Capital Market Supervisory Agency, Indonesia Stock Exchange (IDX) Investors, Legal Profession (Advocate), as well as the Independent Accountants Professional Appraisal .

The development of the audit committee in Indonesia, very late compared to other countries. This is partly due to the new government established a policy regarding the application of the audit committee on State-Owned Enterprises (SOEs) in 1999 certain Additionally, the suggestion of Bapepam to public listed companies to have an audit committee in 2000 set a new view of the importance the existence of the Audit Committee in improving the performance of the company, especially from the aspect of control, the audit committee needs to get the attention of management and the Board of Commissioners and the parties acting as a regulator such as the Minister of Finance, OJK, and the Indonesia Stock Exchange.

### **II.3 Internal Audit**

The scope of internal audit and the task is very widely depending on the demand of a large organization and management of the organization concerned. In general internal audit activities, among others: (1) review the accounting and internal control systems; (2) examination of the management of financial information and operating companies; (3) an examination of whether the economic activities of the company including non-financial controls of the organization.

The existence of an internal audit is needed to support the responsibilities of the audit committee. In performing its duties, the internal auditor shall perform professional responsibilities wisely, dignity, and honor. Internal auditors must consider the legislation in force. Violation of the standards of conduct set out in the code of conduct can result in revocation of membership of an organization's internal auditor profession (Konsorsium Organisasi Auditor Internal, 2004: 6).

Zumei-Li, et.al (2013) found the internal audit department has been given a limited mandate which affects the effectiveness of internal control of listed Manufacturing Companies in China

### **II.4 Internal Control**

In achieving its goals, management of the company begins with identifying and establishing customer needs and resource availability, as well as what activities should be done to manage the activity of these resources, so as to meet customer needs and can simultaneously achieve corporate goals. The management of enterprise organizations are not immune from the possibility of risk, resource risk and threat. Therefore require management control in minimizing the risks that may arise. Control (control) is a measure, systems or appliances that provide assurance that the performance of an activity goal can be achieved.

Based on the facts, although it has been designed and apply internal control turns out some companies experiencing financial crisis to occur corporate collapse. Therefore investors, financial institutions, banks and securities firms sharpen its oversight of the company to gain confidence that the funds invested in addition to obtaining the results, well amam through its reliance on internal control.

Internal control is inherent in every business cycle. The process continues and will affect the performance of a profitable business. Internal control as a basis of resilience in the face of competition, the economy, the growth of technology, customer dissatisfaction and destruction of value. Based on the concept of internal control objectives in harmony and in line with continuity and business challenges to create value as the company's main goal. Therefore, internal control is an integral part of the business cycle, determining the strategy, setting goals and objectives. Without exception the internal controls established for: (1) Increase the market share, (2) improve better performance, (3) improve the quality of the product, (4) customer satisfaction and (5) increase the value of the holder of separation (Root, 1998).

According to COSO (1992), control is defined as a process that is run by a board of commissioners through the audit committee, management and other personnel designed to provide reasonable assurance of achieving the three classes of the following objectives: effectiveness and efficiency of operations, financial reporting could trust, and obedience the legislation.

Based on the above definition of internal control, it appears that the board of commissioners (board of directors) through the audit committee partially responsible for the company's internal control. Commissioners through the audit committee should obtain assurance that internal control is effective in minimizing the risk, and the role of management is to implement policies commissioners about the risks and controls. In fulfilling its responsibilities, management should identify and evaluate the risks faced by the company to gain the attention of the board of commissioners in designing, implementing, and monitoring the systems to be implemented in accordance with the policies of the board of commissioners (The Institute of Chartered Accountants, 1999).

Internal control is a series of actions, policies, methods and procedures as a process that involves people in carrying out the organization's overall operation. Internal control is in the process of management, planning, implementation and monitoring involving commissioners, management and other personnel to achieve: 1) The purpose of the operation by using its resources efficiently and effectively, 2) presentation and disclosure of reliable financial statements , and 3) encourage compliance with the legislation prevailing (Root, 1998).

Various opinion on internal control above, interpreted that involves all the organs of internal control of the company. Shareholders as owners may not directly supervise the activities of the company, but the investment and the investment can be secured, meaning it needs internal control. Commissioners through the audit committee as one of the organs of the company providing strategic role, thus requiring also internal control to provide assurance that directed can be implemented and adhered to, so that the internal control function as media scrutiny.

Directors, one of its functions is to make the planning, how planning can be implemented by all staff in accordance with the planned also require internal control. Means the application of an adequate internal control as a process that is executed by all the people involved are expected to provide reasonable assurance that all regulations, policies, methods and procedures adhered to, which means that the implementation of the operation can be run effectively and efficiently and ultimately produce financial information that can be trusted by all parties.

Based on the literature, the exposure hypothesis is formulated as follows:

Ha: The role of audit committees and internal auditors effect on internal control either partially or simultaneously

### **III. Research Methods**

The research design used in this research is that the causal explanation or explanatory research study as it aims to explain the causal and correlational relationships between variables through hypothesis testing. This study aimed to explore the facts and the factual information collected from respondents using a questionnaire. Population and sample of this research is sharia banks in Indonesia. Participants were used as responen in this study were the officials at Islamic banks in Indonesia, which has served as: commissioner, sharia supervisory board, audit committee, and internal auditors. The number of questionnaires distributed 100 pieces, but returned questionnaires only 80 and that can be processed as many as 72 questionnaires.

Variables consisted of the independent variables and the dependent variable. The independent variables in this study are: The role of the Audit Committee (X1) and Internal Audit (X2), while the dependent variable is: Internal Control (Y). Questionnaire is consisted of 27 questions. Research instrument contains 9 questions about the role of audit committees, internal auditors 8 questions about the role, and 10 questions on internal control effectiveness. All question items were measured on a scale of 1 to 5 Likert method used to analyze the data of this study is multiple regression.

### **IV. Results**

Based on the test results can be seen in the output below, it appears that the simultaneous role of the audit committee and the internal auditor's role simultaneously affect the internal controls while partially the effect is variable internal auditors.

**Table 2. Resume of Statistics Test**

Adjusted R Square		.361
F – test	F	21.098
	Sig	.000 <sup>a</sup>
t - test	Sig - ACR	.064
	Sig - IAR	.000

Based on the table above the role of audit committees and internal auditors affect the effectiveness of internal control in Islamic banks amounted to 36.1%. The influence of other variables was 63.9%. These variables are believed to sharia supervisory board, management commitment, corporate governance, and so forth.

The audit committee has no effect on the internal control. The results of this study support Sommer (1991) in Manao (1997) argued that the audit committee in many companies are still not doing a good job. Sommer opinion, many audit committees are merely doing routine tasks, such as review reports and the selection of the external auditor, and not to question critically and analyze in depth the conditions of control and execution of responsibilities by management. The cause is suspected not only because many of them do not have adequate competence and independence, but also because many do not understand the role of the principal. The results of this study do not support Xie et.al (2003) which states the audit committee is responsible for overseeing the internal control over financial reporting as well as research results Hoitash et.al (2009), the audit committee and the board of commissioners relating to the quality of internal control. In Islamic banks in Indonesia, allegedly because the audit committee has not been influential in Islamic Banking possibility that bank costumer more attention sharia compliance aspects than financial performance aspects (Dusuki, 2008).

Internal auditors effect on internal control. The results of this study support the Tugiman (2000) and Cahill (2006). Tugiman (2000) stated the company's internal auditors play a role in implementing the company's internal control. Effective internal control significant effect on firm performance. Edward Cahill (2006) stated that the interaction between the internal auditor and the audit committee is critical to effective internal controls that would be able to prevent fraud.

## **V. Conclusion and Implications**

Based on the hypothesis test results can be summarized as follows:

1. The audit committee does not affect the internal control. The results of this study support Sommer (1991) in Manao (1997) argued that the audit committee in many companies are still not doing a good job. However, the results of this study do not support Xie et.al (2003) which states the audit committee is responsible for overseeing the internal control over financial reporting as well as



research results Hoitash et.al (2009), the audit committee and the board of commissioners relating to the quality of internal control.

2. Internal auditors effect on internal control. The results of this study support the Tugiman (2000), Cahill (2006) and Zumei-Li, et.al (2013). Tugiman (2000) stated the company's internal auditors play a role in implementing the company's internal control. Effective internal control significant effect on firm performance.

The implications derived from this study are:

1. Between the internal auditors and the audit committee must be established appropriate communication processes are well stated by Cohen, et.al (2007) the process of communication between the audit committee, auditors, and the board of commissioners may affect the quality of financial reporting, internal control, environmental control, and performance of internal auditors.
2. Some of the audit committee who merely perform routine tasks, such as review reports and the selection of the external auditor, and not to question critically and analyze in depth the conditions of control and execution of responsibilities by management. The cause is suspected not only because many of them do not have adequate competence and independence, but also because many do not understand the role of the principal. The implication that the audit committee should be selected people who understand the duties and functions in the work, competence and independence.
3. The role of audit committees and internal auditors should be better by understanding their respective duties and maintain the competence and independence so that better internal control and can eventually produced financial statements that have reliable quality.

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