

The Effect of Internal Control Implementation and Sharia Supervisory Board Role on the Quality of Financial Reporting in Zakat Management Organization

¹Elis Mediawati and ²Tettet Fitrijanti

¹Department of Accounting, Universitas Pendidikan, Jawa Barat, Indonesia

²Department of Accounting, Padjadjaran University, Jawa Barat, Indonesia

Abstract: Public trust is closely related to the quality of the financial information which is presented by Zakat Management Organization (ZMO). The information will be useful if the information is able to support the community decision-making to entrust their zakat to ZMO. Sharia Supervisory Board (SSB) is a very important organ in the Islamic Financial Institutions (IFIs), SSB ensures all the objectives of Islamic governance are achieved which includes directing, reviewing and supervising all the activities of IFIs in order to adhere to sharia (Mediawati). Internal control is necessary to obtain the quality of financial reporting. Financial statements are credible information sources by the financial statements users to determine the performance of management and the company's financial position. To produce quality financial reports it is required financial reporting quality. It should also be supported by internal control over quality financial reporting Internal control is necessary to obtain the quality of financial reporting (Mediawati). This study aims to determine the relation role of sharia supervisory board and internal control on the quality of financial reporting. The method which is used in this study is a survey method. The unit of analysis in this study is the ZMO in Indonesia. The respondents in this study are director, member of the supervisory board of sharia as well as Zakat collection and utilization. The hypothesis testing uses moment product moment correlation and coefficient of determination (R^2). The result of this research is the relation of sharia supervisory board role and internal control with the quality of financial reporting is positive and very strong.

Key words: Internal control, sharia supervisory board, quality of financial reporting, zakat management organization, product moment

INTRODUCTION

Zakat Management Organization (ZMO) is a lot in Indonesia. ZMO is tasked to collect, manage and distribute zakat. The purpose of this zakat management includes improving services for the public in giving zakat so that the results and efficiency of zakat are increased. Zakat is an obligation that must be fulfilled by a muzaki (the person who is obliged to issue zakat) because the rights of others are in the assets which are owned. The right is a right which is owned by eight asnaf on property that is owned by muzaki. Zakat is a worship containing two dimensions of *hablum minallah* or vertical dimension and *hablum minannas* or horizontal dimension. If zakat worship is accomplished properly it will improve the quality of faith, cleanse and purify the soul and develop and deliver a blessing on property which is owned.

Indonesian population is majority Moslem so that the zakat potential in Indonesia is huge. Unfortunately, the amount of zakat in Indonesia is not absorbed well by amil

zakat institutions that exist. There is very noticeable difference between the zakat potential and its acceptance realization by the agency. The cause of the difference is community prefers giving zakat directly to mustahik. Most of community have the view that by giving zakat directly to mustahik it will bring peacefulness compared to entrust it to an institution. In fact, zakat which is given by community does not reach the right target yet when it is administered directly by each of them. There is a possibility of some muzaki give their zakat to the same mustahik. This is where the role of ZMO is actually needed through the zakat management institution it is expected that zakat distribution to mustahik occurs evenly.

Public trust is closely associated with the financial information quality which is presented by ZMO. The information will be useful if the information is able to support the community decision-making to entrust their zakat to ZMO as an institution that is considered a mandate to receive, utilize and distribute zakat which is entrusted by community.

Internal control is necessary to obtain the quality of financial reporting. The importance of internal control and the need for effective internal control can help to ensure the company's operational and financial objectives are met forever (Kinney, 2001; Kinney *et al.*, 1990). The effective internal control process must be comprehensive and involve people at all levels in the company.

To ensure sharia financial institutions according to the Islamic law, each institution shall have the Sharia Supervisory Board (SSB) (Karim, 1990). Karim (1990) argues that SSB is also involved in the accounting policies and sharia reporting it can be justified based on the report which could convince the reader that the financial statements are according to Islamic law.

Financial statements are credible information sources by the financial statements users to determine the performance of management and the company's financial position. To produce quality financial reports it is required financial reporting quality. It should also be supported by internal control over quality financial reporting. Quality financial statement is suitable with generally accepted accounting principles and meets the existing rules and SSB ensures the credibility of financial statements (Karim, 1990).

Conceptual framework: The financial statement is the financial effects overview of transactions and other events which are classified into several large groups according to their economic characteristics. The large group is the elements of financial statements. The elements that are directly related to the measurement of financial position are assets, liabilities, temporary syirkah funds and equity. Meanwhile the elements that are related to performance measurement in the income statement are income and expenses. The statement of changes in financial position usually reflects income statement elements and changes in balance sheet elements thus the basic framework is not identified particularly the elements of the changes statement in financial position.

In contrast to the financial statements which are the output of accounting, financial reporting is not the final product it is a process that starts from the transactions, the selection of accounting policies and then apply the policy. Financial reporting also involves estimates and judgments as well as the disclosures about transactions, events, policies, estimates and judgments that have been made. The quality of financial reporting depends on the quality of each part of the financial reporting process (Gregory and Blanchet, 2000).

According to Committee of Sponsoring Organization of the treadway commission (COSO, 1994), internal control is defined as follows: internal control is a process, affected by entity's board of directors, management

and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

From the quotation, we can conclude that therefore it is important for all managers in an organization to understand the importance of implementing and maintaining effective internal control which is the responsibility. COSO definition of internal control makes it clear that the internal control does not only affect the financial statements which are reliable but indicates that the control should be effective for all operations and compliance with applicable laws and regulations. There are three objectives which are expected by management in designing the effectiveness of internal control, it is associated with:

- The effectiveness and the efficiency of activities
- The information reliability
- Compliance with applicable laws and regulations

According to COSO (1994) the components of internal control consist of the control environment, risk assessment, control activities, information and communication and monitoring. The definition of SSB according to the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI, 2008) is: a Sharia Supervisory Board (SSB) is an independent body of (Sharia scholars) with a (possibility of including) a member other than a sharia scholar who should be an expert in the field of IF Is. The SSB is entrusted with the duty of directing, reviewing and supervising the activities of the IF I in order to ensure that they are in compliance with Islamic Sharia. Rahman (2010) in his book the art of Islamic Banking and Finance states that:

The Sharia board (sometimes called Sharia supervisory committee) in general, certifies every product, finance model and service provided by the RF financial institution. It also ensures that all the transactions are in strict compliance with the principles of Sharia. Based on some of the above opinion it can be concluded that the sharia supervisory board is:

- An independent board
- The members are muamalat fikih experts and the experts in Islamic financial institutions
- To oversee the activities of sharia financial institutions to ensure compliance with the rules and principles of Islamic law

Rosly states that there is the sharia supervisory board role in ensuring the implementation of sharia maqasid and inspecting the implementation of transaction agreement in sharia banks which also affects financial reporting. The SSB independence is very important for financial statements users who require collateral for Islamic transactions and operations of sharia bank. The SSB independence and the external auditor affect the credibility of financial statements (Karim, 1990).

In giving advice, SSB must guarantee all the bank's operations are based on the sharia rules. Karim (1990) the SSB independence is strongly influenced by moral values while the external auditors are largely influenced by economic factors. SSB and independent external auditors are to ensure the credibility of financial statements.

Hypothesis: Referring to the opinions above it can be formulated the hypothesis as follows:

- There is a relation between internal control implementation with sharia supervisory board roles
- There is a relation between the implementation of internal control with the quality of financial reporting
- There is a relation between sharia supervisory board roles with the quality of financial reporting

MATERIALS AND METHODS

The method which is used in this study is a survey method because it has the characteristics that are associated with the objectives to be achieved it is descriptive and verification and the data is collected from a sample that has been determined it is obtained by using a specific data collection tools the questionnaires.

The object of this research are the role of sharia supervisory board and the quality of financial reporting. The research subject is ZMO which operates in Bandung city. The respondents in this study are director, members of Zakat collection and utilization. The data which is obtained from the ZMO respondents will be averaged, so that the opinion of respondents representing each ZMO. The data source which is required in this research will be obtained through the field research by distributing questionnaires and research library (library research). The data quality which is obtained from the respondents through the questionnaire needs to be tested by doing validity test and reliability test to avoid things that are biased and question the validity of this study. The testing hypothesis uses moment product correlation and coefficient of determination (R^2). The more the value of R^2 is closed to one then the independent variable provides almost all the information which is needed to predict the

variation of dependent variable. On the contrary, if the value of R^2 is getting smaller the ability of independent variable in explaining the dependent variation is very limited.

RESULTS AND DISCUSSION

Relation of role of sharia supervisory board and the internal control: The relation of internal control implementation with the role of sharia supervisory board is positive and very strong. This is consistent with the theory of COSO (1994) which states that one purpose of internal control is obedience to the applicable laws and regulations. And in ZMO as one of the non-profit institution for sharia principle has certainly SSB which has the function of supervising the observance of sharia in terms of products, programs and operations. SSB ensures all the objectives of Islamic governance are achieved which includes directing, reviewing and supervising all the activities of IFIs in order to adhere to sharia, it is also that SSB plays an important role in the mechanism of internal control (Haniffa and Hudaib, 2007).

Choudhury and Haque says that the Islamic Financial Institutions (IFIs) has the distinction of Financial institution's non-Islamic aspects of the principles and rules, namely worksheets based on the principles and rules of Islam, making IFIs managed differently and this are determined by the behavior that is based on faith integrated with knowledge. The difference can be seen from the presence of SSB in IFIs. Ghayad (2008) argues that the IFIs should have SSB whose members have adequate knowledge of financial knowledge in addition to sharia, so the SSB can help management develop products according to sharia and give opinions about the level of compliance institutions on the rules of sharia.

Internal control objectives, namely regulatory compliance, achieve operational efficiency and reliability of financial reporting (COSO, 1994). SSB was instrumental in compliance to the rules for ensuring operational IFIs accordance with sharia and on the reliability of financial reporting for financial reporting purposes IFIs is to determine the zakat properly (Karim, 1990) where one of the main functions of SSB is doing the audit of the financial institution of zakat (Briston and Ashker, 1986). In his research argued SSB has three main functions: provision advice, monitoring performance and the audit of Zakah fund (Briston and Ashker, 1986). SSB ensures all the objectives of Islamic governance are achieved which includes directing, reviewing and supervising all the activities of IFIS in order to adhere to sharia it is also that SSB plays an important role in the mechanism of internal control (Haniffa and Hudaib, 2007).

Effect of internal control on the quality of financial reporting: The relation of internal control implementation with the quality of financial reporting is positive and very strong. The results are consistent with the research of petrovits et al which conducts the research on the causes and consequences of internal control problem in non-profit organizations that prove the poor reporting for nonprofit organizations is caused by weak internal control then effects on the organization which is not transparent and is not accountable (Petrovits *et al.*, 2010).

Internal controls consist of organizational planning and coordination of all the methods and measures adopted within a business to retain assets, test the accuracy and reliability of data accounting, operational efficiency promotion and encourage compliance with the provisions of managerial policies. Furthermore, COSO (1994) explains that internal control as a process that is run by a board of directors, management and other personnel of entities that are designed to provide reasonable assurance regarding the achievement of objectives in categories:

- The effectiveness and efficiency of activities
- The reliability of the information
- Compliance with the legal and judicial regulations

Thus the internal control consists of organizational planning and coordination of all the methods and measures adopted within a business to retain assets, test the accuracy and reliability of data accounting, operational efficiency promotion and encourage compliance with the provisions of managerial policies. Altamuro and Beatty (2010) suggested an increase in monitoring and reporting of internal control to improve the quality of financial reporting in the banking industry.

Effect sharia supervisory board role on the quality of financial reporting: The relation of sharia supervisory board role with the quality of financial reporting is positive and very strong. Public trust is closely associated with the financial information quality which is presented by ZMO. The information will be useful if the information is able to support the community decision-making to entrust their zakat to ZMO as an institution that is considered a mandate to receive, utilize and distribute zakat which is entrusted by community. On the other hand, muzakki requires transparency and accountability for the use of zakat funds. SSB has the competence to ensure ZMO accordance with sharia. SSB role has related very strong and positive to the quality of financial reporting. Financial statements are credible

information sources by the financial statements users to determine the performance of management and the company's financial position.

Casper divided the SSB into three, namely certification, supervision and guidance functions. Garas and Pierce (2010) found convincing SSB functions as IFIs activities in accordance with sharia by way of overseeing the management and development support IFIs.

In carrying out its functions, SSB should have the competence religious, legal, social, corporate governance, economic (Garas and Pierce, 2010). IFIs should have SSB who has knowledge of adequate financial knowledge in addition to sharia so the SSB can help management develop products according to sharia (Ghayad, 2008). IFIs managed differently because it is based on principles and rules of Islam and that principle must be in implementation and able to be reflected in the behavior based upon the faith that is integrated into the knowledge.

Financial crimes can be prevented in IFIs because there are laws quran and hadith which form the basis of rules and principles (Jabbar, 2010). And the presence of SSB in IFIs affects the value-added companies and increasing competitive advantage (Nathan and Riebielle, 2007). Chapra and Ahmed (2002) also said that the importance to the role of sharia supervisory board. Islamic bank required quality of internal control to ensure the quality of financial reporting. Rosly suggested a role of sharia supervisory board in ensuring the implementation of maqasid sharia and inspect the implementation of Islamic banks in the transaction agreement which also affect financial reporting.

The independence of SSB is very important for users of financial statements requires collateral for all transactions and operation sharia in Islamic bank. SSB and the independence of the external auditor affect the credibility of financial statements in giving advice; SSB must ensure that all the bank's operations in accordance with the rules of sharia (Karim, 1990). The independence of SSB strongly influenced by moral values while an external auditor is mostly influenced by economic factors. SSB and independent external auditors to ensure the credibility of financial statements. This means the SSB role passively overseen the credibility of financial reporting (Board, 2016).

CONCLUSION

Based on the results of statistical calculations, it is concluded that the relation of sharia supervisory board role and internal control with the quality of financial reporting is positive and very strong. Financial statements are credible information sources by the financial

statements users to determine the performance of management and the company's financial position. Therefore, the role of the SSB and implementation of internal control can improve the quality of financial reporting that will ultimately result in increased public confidence in the ZMO.

REFERENCES

- AAOIFI., 2008. Governance standard for Islamic Financial Institutions. Accounting and Auditing Organization for Islamic Financial Institutions, Manama, Bahrain.
- Altamuro, J. and A. Beatty, 2010. How does internal control regulation affect financial reporting?. *J. Accounting Econ.*, 49: 58-74.
- Board, S.S., 2016. Internal control and Sharia supervisory board role in Zakat management organization. *Intl. J. Recent Adv. Multidiscip. Res.*, 3: 1730-1732.
- Briston, R. and E.A. Ashker, 1986. Religious audit: Could it happen here. *Accountancy*, 98: 120-121.
- COSO., 1994. Internal control integrated framework. American Institute of Certified Company, Durham, North Carolina.
- Chapra, M.U. and H. Ahmed, 2002. Corporate governance in Islamic financial institutions. Islamic Development Bank Islamic Research and Training Institute, Jeddah, Saudi Arabia.
- Garas, S.N. and C. Pierce, 2010. Shari'a supervision of Islamic financial institutions. *J. Financial Regul. Compliance*, 18: 386-407.
- Ghayad, R., 2008. Corporate governance and the global performance of Islamic banks. *Humanomics*, 24: 207-216.
- Gregory, J.J. and J. Blanchet, 2000. Assessing quality of financial reporting. *Accounting Horiz.*, 14: 353-363.
- Haniffa, R. and M. Hudaib, 2007. Exploring the ethical identity of Islamic banks via communication in annual reports. *J. Bus. Ethics*, 76: 97-116.
- Jabbar, S.F.A., 2010. Financial crimes: Prohibition in Islam and prevention by the Shari'a Supervisory board of Islamic financial institutions. *J. Financial Crime*, 17: 287-294.
- Karim, R.A.A., 1990. The independence of religious and external auditors: The case of Islamic banks. *Accounting Auditing Accountability J.*, 3: 33-44.
- Kinney, W.R. Jr, M.W. Maher and D.W. Wright, 1990. Assertions-based standards for integrated internal control. *Accounting Horiz.*, 4: 1-8.
- Kinney, W.R. Jr., 2001. Accounting scholarship: What is uniquely ours?. *Accounting Rev.*, 76: 275-284.
- Nathan, S. and V. Ribiere, 2007. From knowledge to wisdom: The case of corporate governance in Islamic banking. *Vine*, 37: 471-483.
- Petrovits, C., C. Shakespeare and A. Shih, 2010. The causes and consequences of internal control problems in nonprofit organizations. *Social Sci. Res.*, 1: 1-45.
- Rahman, Y.A., 2010. *The Art of Islamic Banking and Finance: Tools and Techniques for Community Based Banking*. John Wiley & Sons, Hoboken, New Jersey isBN:978-0-470-44993-6, Pages: 397.