Al-Furqon
Jurnal of Islamic Economics, Management and Finance
Volume 1 Nomor 2 April 2026
P-ISSN: xxxx-xxxx E-ISSN: xxxx-xxxx

QUALITATIVE ANALYSIS OF THE ROLE OF INTERNAL AUDIT IN CONTROLLING NON-PERFORMING FINANCING (NPF) IN ISLAMIC BANKS IN INDONESIA

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Abstract

This study aims to analyze the role of internal audit in controlling non-performing financing (NPF) in Islamic banking in Indonesia. The research employs a qualitative approach using a literature review method, drawing on various scientific sources such as journals, books, and relevant publications. The findings indicate that internal audit plays a significant role as a supervisory mechanism, an early risk detection tool, and an evaluator of the effectiveness of internal control systems and financing risk management. Internal audit also contributes to fraud prevention and ensures compliance with Sharia principles. The causes of NPF are influenced by internal factors such as weak financing analysis, low operational efficiency, and ineffective internal control systems, as well as external factors including inflation, economic growth, and customer characteristics. Strategies to control NPF include preventive measures, strengthening risk management, improving human resource quality, and resolving problematic financing through restructuring and gradual settlement approaches. The integration of internal audit with risk management has proven to enhance the effectiveness of financing control and reduce NPF levels. Therefore, internal audit plays a crucial role in maintaining the stability and performance of Islamic banking in Indonesia.

Keywords: Internal Audit, Islamic Banking, Non-Performing Financing, Risk Management, Internal Control

INTRODUCTION

The development of the Islamic banking industry in Indonesia has shown significant growth in recent years, marked by increases in assets, financing, and the number of customers. This condition reflects the growing public trust in the Sharia-based financial system. However, the risk of non-performing financing (NPF) remains a major challenge in maintaining the stability of Islamic banking. NPF is an important indicator in assessing asset quality and bank soundness because high levels of problematic financing can negatively affect profitability and public confidence. Research shows that internal factors such as operational efficiency and the quality of financing management significantly influence NPF levels (Kuswahariani et al., 2020). Other findings also emphasize that financial ratios such as BOPO and ROA determine financing stability in Islamic banks (Lestari et al., 2021).

The control of problematic financing is an essential part of risk management in Islamic banking. The control process is carried out through strict financing feasibility analysis and the implementation of effective internal supervision systems. Internal audit has a strategic role in ensuring that all financing procedures are implemented in accordance with applicable policies. Internal audit also functions as an early detection mechanism for financing risks that may develop into NPF. Previous studies indicate that the effectiveness of internal audit contributes to improving the quality of financing risk control (Fatimah & Hamdan, 2022). This role becomes increasingly important in maintaining the operational stability of Islamic banks amid continuously evolving economic dynamics (Anggriana et al., 2022).

The role of internal audit in Islamic banking is not limited to technical supervision but also includes monitoring compliance with Sharia principles. The characteristics of Sharia financing, which are based on contractual agreements (*akad*), require conformity between operational practices and Sharia principles. Internal audit is expected to integrate risk control and Sharia compliance simultaneously. Weaknesses in the internal supervision system may lead to increased financing risk and declining financing portfolio quality (Mutamimah & Chasanah, 2012). Other studies also show that weak internal audit functions may reduce the effectiveness of financing control in Islamic banks (Arifin et al., 2023).

External factors such as macroeconomic conditions also contribute to increasing NPF. Variables such as inflation, interest rates, and economic growth affect customers' ability to fulfill their financing obligations. Nevertheless, internal factors remain the primary determinant in controlling financing risk. Effective internal audit can assist management in identifying system weaknesses, improving financing procedures, and enhancing the quality of decision-making. The strategic role of internal audit as part of the management control system has been proven capable of reducing financing risk levels (Lubis & Siregar, 2024). Other studies affirm that internal audit serves as a management partner in managing risks sustainably (Arafah et al., 2023).

The urgency of strengthening the role of internal audit in controlling problematic financing continues to increase along with the complexity of Islamic banking operations. Integration between internal control systems and risk management is key to maintaining the financial stability of banks. Studies specifically examining the role of internal audit in controlling NPF remain relatively limited; therefore, deeper analysis is needed to understand the relationship between the two. This study aims to qualitatively analyze the role of internal audit in controlling problematic financing in Islamic banks in Indonesia by referring to various empirical findings from previous studies.

METHOD

This study employs a qualitative approach using a literature review method aimed at comprehensively examining various previous studies related to the role of internal audit in controlling non-performing financing (NPF) in Islamic banking. A qualitative approach was chosen because it provides a comprehensive understanding of the phenomenon being studied through descriptive analysis of secondary data. This approach enables researchers to systematically interpret empirical findings to obtain a holistic understanding of the relationship between internal audit and financing risk control (Sugiyono, 2019).

The type of data used in this study is secondary data obtained from various scientific sources such as accredited national journals, textbooks, and other scientific publications relevant to the research topic. The secondary data focuses on studies discussing internal audit, risk management, and problematic financing in Islamic banking. The selection of secondary data is based on the consideration that these sources have undergone scientific processes and possess high validity, making them a strong basis for analysis in literature research (Ratnaningtyas et al., 2023).

The data collection technique was carried out through systematic literature searches using scientific databases such as Google Scholar, Garuda, and other national journal portals. The search was conducted using keywords such as “internal audit in Islamic banks,” “Non-Performing Financing (NPF),” “control of problematic financing,” and “Islamic banking risk management.” This technique aims to obtain literature sources relevant to the research focus. This process is known as a literature study, which gathers data from various credible and accountable scientific references.

The criteria for selecting literature in this study include relevance to the research topic, relatively recent publication years, and accessibility of the sources used. Priority was given to scientific journals with good academic quality and those indexed nationally and internationally. The data analysis technique used descriptive qualitative analysis by reviewing, comparing, and synthesizing various findings from previous studies related to internal audit and problematic financing control. The analysis process was conducted by grouping data based on specific themes such as the role of internal audit, factors causing NPF, and financing risk control strategies, followed by drawing conclusions aligned with the research objectives (Rachman et al., 2024).

The research stages began with identifying issues related to problematic financing in Islamic banks, followed by collecting relevant literature, selecting sources based on predetermined criteria, systematically analyzing the data, and drawing conclusions. All stages were carried out in a structured manner to ensure high validity and provide scientific contributions in understanding the role of internal audit in controlling Non-Performing Financing in Islamic banking.

RESULTS AND DISCUSSION

The Role of Internal Audit in Controlling Non-Performing Financing

Internal audit has a strategic role in controlling non-performing financing or Non-Performing Financing (NPF) in Islamic banking. Internal audit functions as a supervisory mechanism that ensures all financing processes are carried out in accordance with procedures and prudential principles. The implementation of internal audit is conducted through systematic stages, starting from audit planning, audit execution, reporting, and follow-up of audit findings. This process enables internal auditors to identify potential financing risks at an early stage and provide recommendations for improving systems that are not yet optimal (Prasetyo, 2016). This mechanism demonstrates that internal audit not only functions as a monitoring tool but also as part of a comprehensive financing risk control system.

The role of internal audit is also closely related to the effectiveness of the internal control system in managing non-performing financing. A strong internal control system can minimize the risk of problematic financing through the implementation of principles such as risk assessment, control activities, and continuous monitoring. Research shows that although internal control systems have been properly implemented, non-performing financing may still occur if the processes of risk identification and mitigation are not conducted comprehensively (Fauziah et al., 2024). This indicates that internal audit plays an important role in evaluating the effectiveness of internal controls and ensuring that all financing risks are managed optimally.

Internal audit also contributes to the prevention of broader risks, including fraud that may trigger non-performing financing. Internal audit, together with the internal control system, has been proven to have a positive and significant effect in preventing fraud in Islamic banks (Wibowo, 2023). Fraud prevention is essential because fraudulent activities in the financing process can increase the risk of default and worsen the quality of the financing portfolio. Therefore, internal audit not only plays a role in detecting errors but also in preventing irregularities that may contribute to higher NPF levels.

The effectiveness of internal audit in controlling non-performing financing is also influenced by its integration with risk management. Internal audit assists in evaluating risk management policies and ensuring that all financing activities comply with established standards. Research indicates that internal audit plays an important role in improving the effectiveness of risk management in Islamic banking, particularly in minimizing financing risks (Lubis & Siregar, 2023). This integration enables banks to identify, measure, and control financing risks more comprehensively.

In addition, internal audit also plays a role in improving the quality of financing control through the evaluation of procedures for resolving non-performing financing. Effective internal control has been proven to support the resolution of problematic financing and maintain the financial stability of banks. Research shows that a strong internal control system can improve the effectiveness of handling non-performing financing, although some weaknesses in implementation still exist (Balqis et al., 2023). This indicates that internal audit has an important role in strengthening the internal control system and improving the quality of financing management.

Factors Causing Non-Performing Financing (NPF)

Non-performing financing or Non-Performing Financing (NPF) is a major indicator in assessing the soundness of Islamic banking. A high NPF ratio indicates inefficiency in financing management and an increased risk of customer default. The factors causing NPF can be classified into internal and external factors. Internal factors are generally related to the bank's management condition, such as weak financing analysis and suboptimal internal control. Research shows that financing characteristics and the quality of customer analysis significantly influence the occurrence of problematic financing, leading to an increase in NPF (Putra & Mawardi, 2017). This demonstrates that errors in the financing distribution process are one of the main causes of rising NPF levels.

Another internal factor contributing to the increase in NPF is the bank's financial ratios, particularly the Financing to Deposit Ratio (FDR) and operational efficiency. A high FDR reflects aggressive financing distribution that is not balanced with proper risk management, thereby increasing the potential for NPF. Research indicates that FDR has a significant influence on NPF in the short term, while other factors such as assets and exchange rates have a more limited effect (Nasir & Khomariyah, 2021). In addition, low operational efficiency can increase the bank's operational costs, which ultimately affects financing quality and increases NPF (Rofi'ah & A'yun, 2019). These conditions indicate that internal bank factors play a dominant role in influencing NPF levels.

External factors also have a significant impact on increasing NPF, especially macroeconomic conditions. Variables such as inflation, economic growth, and exchange rates affect customers' ability to fulfill their financing obligations. When economic conditions deteriorate, customers' repayment ability declines, thereby increasing the risk of non-performing financing and leading to higher NPF levels. Research shows that, in the long run, inflation and economic conditions significantly influence the increase of NPF in Islamic banks (Nasir & Khomariyah, 2021). This confirms that controlling NPF depends not only on internal factors but is also influenced by broader economic conditions.

In addition to economic factors, customer characteristics are also important in determining NPF levels. Financing dominated by the small and medium enterprise (SME) sector tends to have a higher risk of NPF due to its dependence on fluctuating business conditions. Research shows that most problematic financing originates from the small business sector, which has relatively low business resilience (Putra & Mawardi, 2017). The mismatch between customer risk profiles and the type of financing provided can also increase the potential for NPF.

Strategies for Controlling Non-Performing Financing

Strategies for controlling non-performing financing or Non-Performing Financing (NPF) are important measures in maintaining the stability of Islamic banking. High levels of NPF can reduce asset quality and disrupt the financial performance of banks; therefore, comprehensive strategies are required to control it. One of the main strategies implemented is early prevention through improving the quality of financing analysis and applying prudential principles. Islamic banks need to strengthen customer selection processes by considering aspects such as character, capacity, and business conditions in order to minimize the risk of problematic financing from the beginning (Sugianto, 2022). This preventive approach is an effective initial step in reducing the potential increase in NPF.

In addition to preventive strategies, NPF control is also carried out through strengthening risk management and improving the quality of human resources. Enhancing employee competence and strengthening risk management systems are important factors in identifying and managing financing risks. This strategy includes stricter supervision of distributed financing and periodic evaluation of financing portfolio quality. Research shows that strengthening risk management and supervisory quality can improve the effectiveness of controlling non-performing financing and significantly reduce NPF levels (Sugianto, 2022). This indicates that internal bank factors play a major role in determining the success of NPF control.

Another strategy in controlling NPF is through handling non-performing financing that has already occurred. This handling is conducted through persuasive approaches and financing restructuring. Financing restructuring is generally carried out using the 3R method, namely rescheduling, reconditioning, and restructuring (Fauziah et al., 2023). This approach aims to assist customers in fulfilling their financing obligations while minimizing the bank's losses. Restructuring strategies have proven to be one of the most effective methods for reducing NPF levels when implemented appropriately and consistently.

In addition to restructuring, strategies for resolving problematic financing can also be conducted through non-litigation and litigation channels. Non-litigation settlement is carried out through persuasive approaches between the bank and customers, while litigation settlement is conducted through legal institutions such as courts or Islamic arbitration bodies. Research shows that the resolution of problematic financing can be carried out gradually, starting from persuasive approaches to legal action if necessary (Iswandi, 2022). This strategy provides flexibility for banks in handling problematic financing according to customer conditions.

NPF control strategies also include efforts to rescue financing by providing relief to customers experiencing payment difficulties. Such relief may include extending repayment periods, reducing installment amounts, or adjusting financing schemes. However, if customers do not demonstrate good faith, banks may take firm actions such as collateral confiscation as a last resort. Research shows that a combination of persuasive approaches and firm actions is necessary to control problematic financing and prevent further increases (Daimah & Farizki, 2021). This approach aims to maintain a balance between the interests of the bank and the customer's repayment ability.

Integration of Internal Audit in Financing Risk Management

The integration of internal audit into financing risk management is an important element in improving the effectiveness of risk control in Islamic banking. Internal audit functions not only as an evaluation tool but also as part of the risk management system that plays a role in identifying, assessing, and controlling financing risks comprehensively. The implementation of risk-based internal audits enables auditors to focus on areas with high levels of risk, including the potential occurrence of Non-Performing Financing (NPF).

The integration between internal audit and risk management also encourages the creation of a more comprehensive and coordinated risk management system. Internal audit plays a role in providing strategic recommendations to management regarding improvements in financing policies and the enhancement of internal control quality. Research shows that the synergy between internal audit and risk management can improve transparency, efficiency, and the resilience of Islamic banks in facing various financing risks (Marom, 2025). Furthermore, the existence of internal audit integrated with the internal control system can help minimize potential losses caused by problematic financing and improve the quality of management decision-making (Syahril, 2014).

CONCLUSION

Based on the results of the literature review, internal audit has a strategic role in controlling non-performing financing (Non-Performing Financing/NPF) in Islamic banking in Indonesia. Internal audit functions not only as a supervisory mechanism but also as an early detection tool for potential financing risks and as an evaluator of the effectiveness of the internal control system. The integration of internal audit with risk management has proven capable of improving the quality of financing management, enhancing operational procedures, and preventing irregularities such as fraud that may worsen NPF levels.

In addition, the factors causing NPF are influenced by internal factors such as weak financing analysis, operational efficiency, and the quality of risk management, as well as external factors such as macroeconomic conditions and customer characteristics. Therefore, NPF control strategies must be implemented comprehensively through preventive approaches, strengthening risk management, improving the quality of human resources, and handling problematic financing through restructuring and gradual resolution. Thus, strengthening the integrated role of internal audit is the key to maintaining the stability and soundness of Islamic banking.

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