

## CHAPTER FOUR

### THEORETICAL FRAMEWORK

#### 4.1 INTRODUCTION

In the previous chapter, the researcher provided a detailed review of relevant literature. In this chapter, the researcher reviews relevant theoretical underpinnings for the study and also developed conceptual framework to be tested in the study. The function of Shariah audit will be highlighted in the model that acts as a monitoring mechanism in the IFIs. On the later part, this study will concentrates on the theories and their importance in enhancing understanding on the Shariah audit function. These include the agency theory, stakeholder's theory and Ibn Khaldun's theory. In addition, based on the audit expectation gap framework by Porter (1993), this research extends the model done by Porter (1993) by looking from the Shariah audit perspectives.

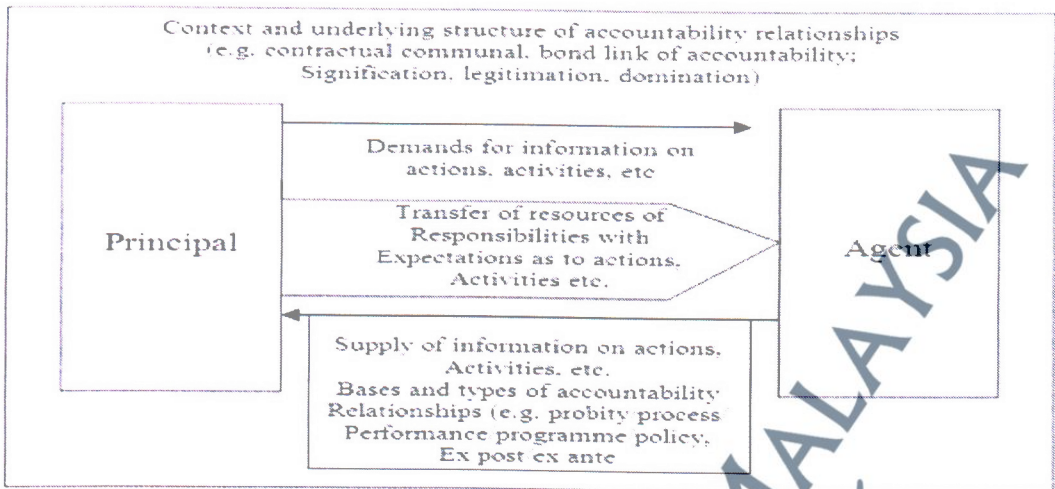
#### 4.2 AGENCY THEORY

Given the scope and process of Shariah audit function highlighted in the Shariah Governance Framework Model (BNM, 2010), other areas need to be properly addressed in the framework. In fact, the scope of the Shariah audit function highlighted in the framework needs to be emphasised. The framework shall also address issues of competency and independence of the Shariah auditors, operational process of Shariah audit function and reporting outcomes based on the findings. This is to enable the IFI to assess whether a sound and effective internal control system for Shariah compliance have been implemented. Based on the model discussed above, this research identifies

three important theories related to governance and Shariah audit characteristics. They are:

- a. Agency theory
- b. Stakeholder theory
- c. Ibn Khaldun's theory

This research identifies agency theory as a starting point in developing a theoretical framework. Audits serve a fundamental purpose of promoting confidence and reinforcing trust in financial information. The core element in agency theory is the conflict of interest between principals and agents. A principal (shareholder) assigns the power of the decision maker to an agent (manager) who, as an agent, executes their duties on behalf of the principal. The principal-agent relationship, as depicted in agency theory, is important in understanding how the audit has developed. Principals appoint agents and delegate some decision-making authority to them. In so doing, principals place trust in their agents to act in the principals' best interests. However, as a result of information asymmetries between principals and agents and differing motives, principals may lack trust in their agents and may therefore need to put in place mechanisms, such as the audit, to reinforce this trust. The agency theory model can be illustrated through the figure below:



**Figure 4: Agency Theory Model**

\*Sources: Afifuddin and Nabihah (2010)

Agency theory is a useful economic theory of accountability, which helps to explain the development of the audit. One of the main objectives of agency theory is to enhance accountability through providing a fair information flow between the principals and the agents. This means that auditing plays a very significant role in providing information. Islam has developed its concept of accountability or *Taklif*, the term used by Al-Safi (1992), which means that all Muslims are accountable for their actions or inactions on the Day of Judgement. Al-Safi (1992) notes that:

*“Every person is responsible for his own deeds and everyone has a “book”, as a register of acts in which all deeds small or great are written down. God Almighty will bring all people to life after death and bring them from their graves so that each one of them will meet the result of his deeds, reward or punishment”.*

The concept of accountability in Islam is derived from the Qur’an, which makes reference to the principle of accountability. It is mentioned in Surah Al-Baqarah verse 284 that:

*“To Allah belongs whatever is in the heavens and whatever is in the earth. And whether you manifest what is in your minds or hide it, Allah will call you to account according to it. So He forgives whom He pleases and chastises whom He pleases. And Allah is Possessor of power over all things”.*

This verse highlights two important things. Firstly, whatever is in the heavens and the earth belongs to Allah. No one can claim proprietorship, even in this earthly existence; the human child comes empty handed from his mother’s womb and returns to his grave devoid of all material possessions. Secondly, this verse highlights that man is accountable before Allah for whatever is in his mind, whether he manifests it or hides it. The fundamental concept of Islamic accountability is believed that all resources are made available to individuals in a form of trust. Hence true disclosure of financial facts and accurate information should be freely available to the users (Abu-Tapanjeh, 2009).

In agency theory, an audit is of value to a variety of stakeholders to engender trust and confidence that the directors are running the company in the shareholders’ best interests. Even though the fact that auditors are agents too and will have their motives and interests which, if the simple agency model were applied, would result in a lack of trust in auditors and an on-going need to find further mechanisms for aligning the interests of shareholders, directors and auditors. Thus, the auditors who act as an agent need to ensure that they are accountable for the information that they provide to the shareholders.

Lewis (2006) mentioned that “Allah repeats the word Hisab or ‘account’ as the root of accountability, more than eight times in different verses”. *Taklif* or account is differentiated from its non-Islamic counterparts by insisting that each person be

responsible for his deeds (Abdul Rahman, 1998). This, also means that people must accept all the duties and liabilities as well as the benefits of any ownership or responsibility. On the other hand, the final decisions of our actions (right or wrong) will be decided by Allah SWT. Similarly, in a business enterprise, both management and the providers of capital are accountable for their actions both within and outside the firm.

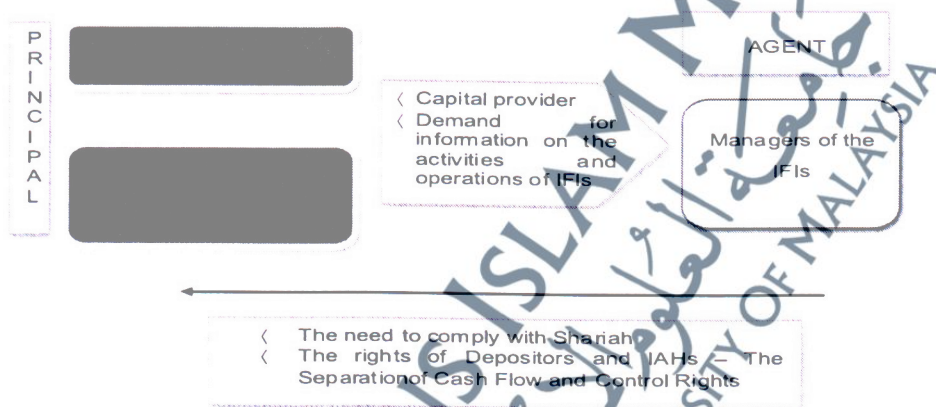
Safieddine (2009) highlights the two key features of agency theory in IFIs:

- 1) The need to comply with the Shariah
- 2) The rights of depositors and Investment Account Holders (IAHs) pertaining to the separation of cash flow and control rights

The depositors, shareholders and investors of the IFIs are concerned their funds are compliant with the Shariah. In the case of IFIs, Muhammad Umer Chapra and Ahmed (2002) observe that agency problems may affect a bank's credibility, as well as its ability to attract investors. They provide evidence that almost 86% of depositors in Bahraini Islamic banks and almost 95% in Sudanese Islamic banks are prepared to withdraw their funds if those banks failed to operate in accordance with the Shariah. While agency problems in conventional companies arise when managers deviate from their duty to maximise shareholders' wealth, any divergence by managers of Islamic financial institutions from placing all supplied funds in Shariah-compliant investments creates an additional source of agency problems (Safieddine, 2009). According to Archer, Karim, and Al-Deehan (1998), Islamic banks must adhere to both the regulations set by the supervisors and the Islamic principles of Shariah.

The separation of cash flow and control rights for a class of investors which is known as Investment Account Holders (IAH) is also one of the characteristic in agency theory in IFIs. Grais and Pellegrini (2006) argued that the depositors or the principals entrusting their resources to the management of the IFIs with the significant difference

that, in their case the agent is appointed by another principal, namely, the shareholder. Consequently, IAHs are not granted the monitoring and control rights that shareholders enjoy and their cash flow rights are separated from the rights to control the investments. The agency issues thus do not solely arise from the separation of ownership and control for shareholders but also from the separation of cash flow and control rights for depositors and investors( Safieddine, 2009). The agency issues in the IFIs can be illustrated in Figure 5 below:



**Figure 5: Agency Theory Issues in the IFIs**

Due to the conflict that arises in relation to the agency theory in IFIs, this study attempts to examine the role of Shariah audit as a mechanism to mitigate the agency issues. The practice of Shariah audit can be seen as a control mechanism in the activities and operations of the IFIs. The Shariah audit function oversees the overall operations of the IFIs and promotes greater transparency and disclosure in reporting. This practice could alleviate agency problems that arise between IFIs and their shareholders, depositors and IAHs because of the poor disclosure in the annual report. From the agency theory perspectives, this research shifts its view from the traditional shareholder value to the stakeholder theory that looks after the interest of a wider circle of stakeholders.

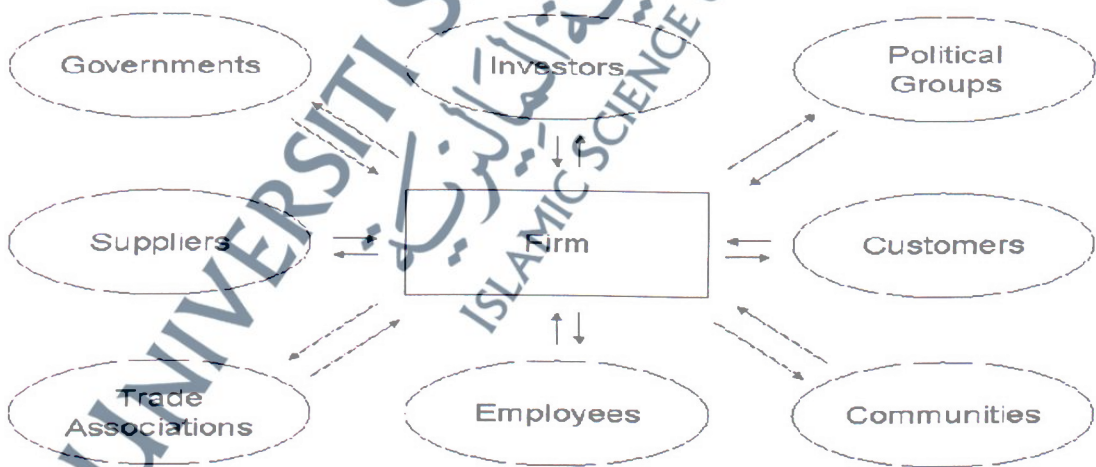
### 4.3 STAKEHOLDER THEORY

The idea behind agency theory received criticisms from the previous scholars (R. Edward Freeman, Wicks, & Parmar, 2004). They claimed that the agency theory provides a short-term perspective and explanation of the purpose of the firm. The scope of agency theory is narrow since it projects the activities of the firm from the perspective of the shareholders only. In addition, according to Archer et al. (1998) there are three types of agency problems. These are:

- 1) The nonpecuniary benefits or perquisites, which the owner-managers of a firm that they only partially own are likely to consume beyond those which a sole owner would consume.
- 2) The problem of adverse selection arising from the use of debt financing under limited liability of shareholders, given that there is an incentive to the latter: (a) to undertake high risk projects that effectively transfer wealth from lenders to shareholders; and (b) to forego new profitable investments which benefit only lenders. Debt financing may also result in a reduction in the market value of the firm when disputes between shareholders and bondholders are resolved through the process of costly bankruptcy.
- 3) Information asymmetry, namely that the principal cannot observe the actions of the agent, whereas the latter is better informed of the firm's performance and prospects.

Freeman (1994) provides an alternative proposition known as the stakeholder theory that suggests a firm's activities should be projected on longer and broader perspectives. According to Freeman et al. (2004), stakeholder theory begins with the assumption that values are necessarily and explicitly a part of doing business. It asks managers to

articulate the shared sense of the value they create, and what brings its core stakeholders together. It also pushes managers to be clear about how they want to do business, specifically what kinds of relationships they want and need to create with their stakeholders to deliver on their purpose. The theory posits that the essence of corporate activity is not only for the benefit of the shareholders but also for the benefit of all relevant stakeholders (including the shareholders) and it is all these relevant stakeholders who should be the main remit of the modern firm (Freeman, 1994; Jensen, 2001). One very broad definition of a stakeholder is any group or individual, which can affect or is affected by an organisation. Such a broad conception would include suppliers, customers, stockholders, employees, the media, political action groups, communities, and governments. A more narrow view of stakeholder would include employees, suppliers, customers, financial institutions, and local communities where the corporation does its business (Donaldson & Preston, 1995). The stakeholder theory model can be illustrated in Figure 6 below:



Source: Donaldson and Preston, 1995

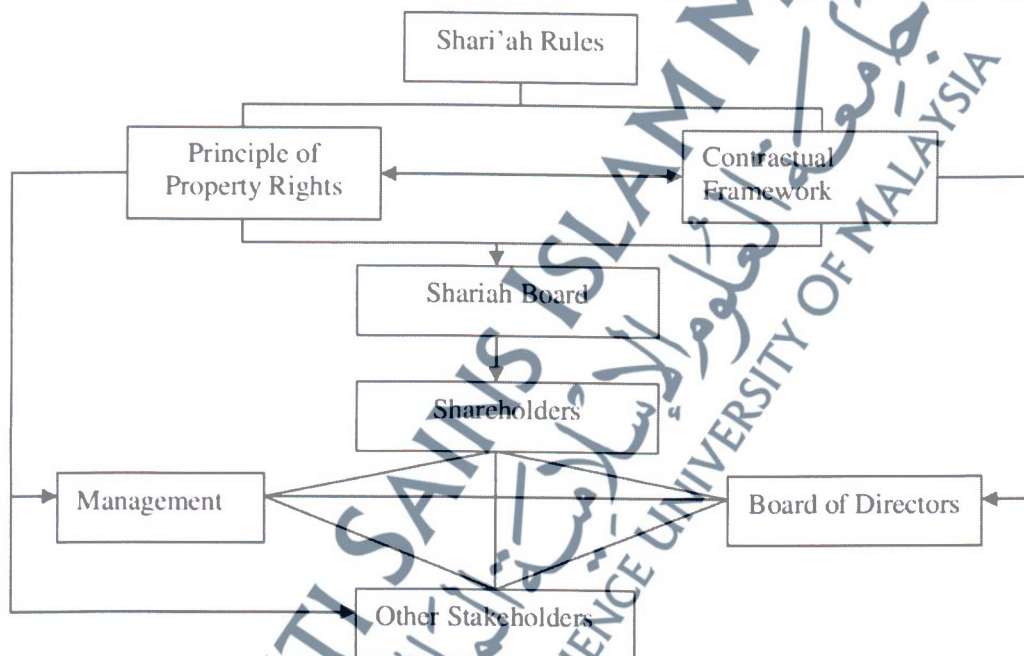
**Figure 6: Stakeholder Theory Model**

\*Source Donaldson and Preston (1995)

According to Chatterjee et.al., (2008), there are two branches of stakeholder theory, that is, the ethical branch and the managerial branch. The ethical branch attributes equal emphasis on fulfilling the expectations of all groups of stakeholders' irrespective of their power. On the other hand, the managerial branch emphasises that company management is expected to meet the expectations of powerful stakeholder groups. However, Sternberg (1997) criticised the ethical branch of stakeholder theory. The author suggests that the ethical branch by requiring managers to fulfil the expectations of all stakeholder groups may result in organisations not meeting the expectations of anyone. Whereas Deegan (2006) mentioned that the managerial branch may stem from the control of limited resources, such as finance and labour, access to media or ability to take legislative action against the company or the ability to influence the goods and services consumed by the company. Gray, Owen, and Adams (1996) highlighted that organisation centred information is a major element that can be employed by the organisation to manage (or manipulate) the stakeholder to gain their support and approval, or to distract their opposition or disapproval. The author found that the objective of Shariah audit practices are consistent with the stakeholder theory expectations, which are to meet not only the shareholders but the stakeholders as well.

From Islamic perspectives on stakeholder theory, according to Iqbal & Mirakhor (2004) and Iqbal & Molyneux (2005), a stakeholder is defined as the one whose property rights are at stake or risk due to voluntary or involuntary actions of the firm. This implies that the firm is expected to preserve property rights of not only the shareholders but also those who have participated in the process of acquiring or earning the firm's property, and those who could be threatened as a result of the firm's operation (Dusuki, 2007). Iqbal & Mirakhor's (2004) main arguments are based on two fundamental concepts of Islamic law namely principle of property rights and

commitment to explicit and implicit contractual agreements that govern the economic and social behaviour of individuals, society and state. These two principles provide strong justification for the notion of classifying Islamic corporate governance as a stakeholder-oriented model (Hasan, 2010). Hasan (2010) outline an overview of the stakeholders' model for Islamic corporate governance which is preoccupied with two fundamental concepts of Shariah principles of property rights and contractual frameworks in Figure 3.5 below:



**Figure 7: Stakeholders Model for Islamic Corporate Governance**

\*Sources from Hasan (2010), pg. 3

Based on the figure above, the governance of any corporation in Islam is ruled by Shariah where all the stakeholders including the shareholders, the management, other stakeholders such as the employees, the suppliers, the depositors and the community. The Shariah board plays a role in advising and supervising the operation of the corporation so as to ensure that it complies with the Shariah principles. The Board of Directors acting on behalf of the shareholders has a duty to monitor and oversee overall

business activities, and the managers have a fiduciary duty to manage the firm as a trust for all the stakeholders and not for the shareholders alone. The other stakeholders such as employees, depositors, and customers have a duty to perform all of their contractual obligations. Furthermore, the state as a stakeholder will be the external institution to provide a regulatory framework and its enforcement.

For the purpose of this thesis, the researcher used stakeholder theory to ensure proper check and balance in the nature of interactions between the business and its stakeholder's through the Shariah auditing process. According to the Shariah, the firms must not violate the property rights of those with whom they interact since these property rights are granted and preserved by Shariah to promote social order and economic development (Iqbal & Mirakhor, 2004). For example, Islam recognises 'self-interest' and permits 'profit-motive' as these are natural motivating forces in all human life. However, self-interest has to be linked to the overall concepts of goodness and justice, which require the preservation of society's well-being and interests. According to Dusuki (2007), firms may strive to maximise their shareholder's wealth as long as they do not create a situation that is socially disruptive or in violation of the norms of Islamic justice. This contradicts the doctrine of self-interest idealised in neoclassical economics.

#### 4.3.1 IBN KHALDUN'S THEORY

Stakeholder theory highlights on the benefit of the stakeholders parties to ensure proper check and balance in the nature of interactions between the business and its stakeholder's. The party related to stakeholders are inline with the components highlighted in the Ibn Khaldun's theory. Chapra (2008) described Ibn Khaldun's theory

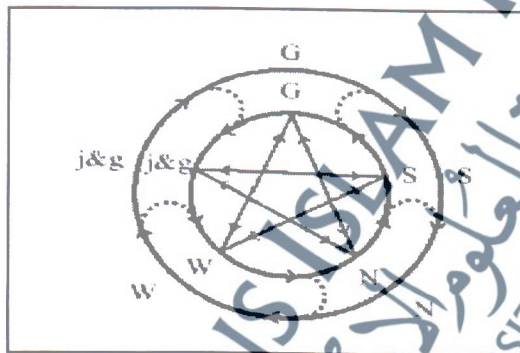
of economic development as according to Toynbee (1935), as a man of extraordinary intellectual capabilities. The theory is based on the Ibn Khaldun's book; the Muqaddimah, which literally means 'introduction' and constitutes the first volume of a seven-volume history which further discussed by Chapra (2006). This research discusses Chapra's (2006) views and interpretation of Ibn Khaldun's theory. Ibn Khaldun's was well aware that the reversal could not be dreamed of without first drawing lessons from history and determine the factors that had led the Muslim civilisation to bloom out of humble beginnings and to decline thereafter. Chapra (2008) added that Ibn Khaldun constructed a model that could help explain the rise and fall of civilisations or the development and decline of economies, both of which are interdependent phenomena in his model. According to Ibn Khaldun, Chapra (2008) stated:

- a) the strength of the sovereign (*al-mulk*) does not materialise except through the implementation of the Shariah,
  - b) the Shariah cannot be implemented except by the sovereign (*al-mulk*),
  - c) the sovereign cannot gain strength except through the people (*al-rijal*),
  - d) the people cannot be sustained except by wealth (*al-mal*),
  - e) wealth cannot be acquired except through development (*al-imarah*),
  - f) development cannot be attained except through justice (*al-adl*),
  - g) justice is the criterion (*al-mizan*) by which God will evaluate mankind,
- and
- h) the sovereign is charged with the responsibility of actualising justice.

Chapra (2006, p. 839) summarises his views relating to the above as follows:

*“the development or decline of an economy or society does not depend on any one factor, but rather on the interaction of moral, social, economic, political and historical factors over a long period of time. One of these factors acts as the trigger mechanism and, if the others respond in the same direction, development or decline gains momentum through a chain reaction until it becomes difficult to distinguish the cause from the effect”.*

He further summarised Ibn Khaldun’s theory into a diagram as follows:



**Figure 8: Interrelationship of Variables of Economic Growth and the Chain Reaction**

Sources: (Chapra, 2008, p. 840)

The above figure shows a multidisciplinary relationship because it links socio-economic and political variables, including the sovereign or political authority (G), beliefs and rules of behaviour or the Shariah (S), people (N), wealth or stock of resources (W), development (g) and justice (j), in a circular and interdependent manner, each influencing the others and in turn being influenced by them. The model derived by Chapra (2008) based on Ibn Khaldun’s theory can be simplified as a strong economic development that requires the

- i. Role of human being which is on moral, institutional, psychological, political, social and demographic factors

- ii. Role of development and justice
- iii. Role of institutions and the state
- iv. Role of wealth
- v. Role of the trigger mechanism.

The theory of economic development as addressed by Ibn Khaldun's has been widely applied in many areas related to *muamalat* such as tax (Abdul Azim, 2006), Islamic microfinance (Dusuki, 2010; Mihajat & Hoetoro, 2010; Obaidullah & Salma, 2008) and sustainable economic development (M. Umer Chapra, 2006, 2008; Mohammad Tahir Sabit, 2010; Salman, 2006). They can also be related to discussions on Shariah audit. This is because Ibn Khaldun's theory can be applied in today's corporate and cooperative entities (Mohammad Tahir Sabit, 2010). The relationship between the factors of economic development as according to Ibn Khaldun's theory based on Chapra's (2008) model with the Shariah audit practices are further elaborate in the following section.

#### 4.3.1.1 Role of Human Being

According to Ibn Khaldun's theory, the role of the human being is the core of everything since "the rise and fall of civilisations is closely dependent on the well-being or misery of the people" (Chapra 2008, p. 840). This includes moral, institutional, psychological, political, social and demographic factors. Based on the previous studies gap arises due to individual factor such as the level of accounting qualification, experiences and age factor (AlJaaidi, 2009; Azham, Teck Heang, Rosli, & Marianne, 2008; Goodwin & Seow, 2002; Teck Heang Teck Heang, Ali, & Bien, 2009).

Abdul Rahman (2008) argues that one of the challenges in implementing Shariah audit would be to produce competent and independent Shariah auditors. He also

suggested that the education and training programme on Shariah audit should equip the Shariah auditor with two basic knowledge i.e. specialised Shariah knowledge as applied in Islamic banking and finance, and accounting and auditing knowledge and skills. The internal auditors of an IFI, who perform the Shariah audit function possess knowledge about accounting and auditing but little knowledge in Shariah (Kasim, 2009).

#### 4.3.1.2 Role of Development and Justice

The second element that supports Ibn Khaldun's theory is the role of development and justice. Chapra (2008, p. 840) derived the concept of development as follows:

*Development in Ibn Khaldun's model does not refer to merely economic growth (Muqaddimah 39 and 347-49; Rosenthal's translation: I.39 and II.243-49). It encompasses all-round human development such that each variable enriches the others (G, S, N, W, j and g) and is in turn enriched by them, contributing thereby to the true well-being or happiness of people and ensuring not only the survival but also the rise of the civilisation.*

This shows that the role of development is interrelated with the role of a human being. People will not perform in their life if there are no developments and the inflow of scholars, artisans, labour and capital that need to take place from other societies is inhibited thereby failing to boost development (Chapra, 2008). Mohammad Tahir Sabit (2010) added that participation in development can be achieved if it is based on justice founded on legal and moral principles. This is where the role of justice takes place. Justice is the key for development. Chapra (2008) highlights that Ibn Khaldun's considers justice so crucial for development that he has a whole section entitled

“injustice triggers the destruction of civilisation”. He mentioned that Ibn Khaldun’s clearly highlight in the Muqaddimah that:

*“Do not think that injustice consists in only taking money or property from its owner without compensation or cause, even though this is what is commonly understood. Injustice is more comprehensive than this. Anyone who confiscates the property of someone or forces him to work for him, or presses an unjustified claim against him, or imposes on him a duty not required by the Shariah, has committed injustice. Collection of unjustified taxes is also injustice; transgression on another’s property or taking it away by force or theft constitutes injustice; denying other people their rights is also injustice” (Muqaddimah:288; Rosenthal’s translation: II. 106-7).*

Development activities include trade, agricultural, industrial, and construction (Mohammad Tahir Sabit, 2010). Participation in all such development activities by all groups should be fair and just. Ibn Khaldun’s also mentioned that the concept of justice cannot be fully realised without *asabiyyah* translated as ‘social solidarity’, ‘group feeling’ or ‘social cohesion’. The concept of *asabiyyah* is widely used by researchers in the Islamic microfinance (Dusuki, 2010; Mihajat & Hoetoro, 2010; Obaidullah & Salma, 2008). From the conventional perspectives, scholars referred the concept of *asabiyyah* as social capital or social infrastructure (Chapra, 2008). The concept of *asabiyyah* “provides protection, makes possible mutual defence as well as the settlement of claims and performance of all agreed activities” (Muqaddimah: 139; Rosenthal’s translation: I. 284). Dusuki (2010) highlights that the concept of *asabiyyah* can be enforced through the formation of group-based lending among poor rural

communities who are normally denied access to credit from mainstream financial institution and market. This will lead to justice as perceived by Ibn Khaldun's since the poor are given the opportunity to take credit from the financial institution. This will boost the development of a country when the concept of fair and just are been implemented. Shariah audit practices in the IFIs should play the role in providing justice to the stakeholders through auditing the overall activities and operations of the IFIs are Shariah compliance. Any matters arising from Shariah noncompliance must be communicated to the stakeholders so that actions will be identified by the management to remedy the situations. In such cases, the stakeholders are aware of the situation and will increase the confidence in the activities and operations of the Islamic banks. This shows that the role in providing justice to the stakeholders through transparent reporting in Shariah audit can be achieved.

#### 4.3.1.3 Role of Institutions and the State

The third element of Ibn Khaldun's theory involves the role of institutions and the state. All countries have their regulations and statutory laws. For a Muslim country, the laws and regulations should be according to the Shariah. According to Chapra (2008):

*"Divine Laws command the doing of good and prohibit the doing of what is evil and destructive" (Muqaddimah: 304; Rosenthal's translation: II. 142). They are, therefore, according to Ibn Khaldun's, "for the good of human beings and serve their interests" (Muqaddimah: 143; Rosenthal's translation: I. 292). The Shariah cannot, however, play a meaningful role unless it is implemented fairly and impartially (Muqaddimah: 39 and 43; Rosenthal's translation: I. 80 and 91-92).*

The role of the state emphasises by Ibn Khaldun characterised as “good governance”. The state carries the responsibility to help the society to conduct businesses, ensuring and detecting fraud, if any, and prevent them from committing any deals that may lead to injustice to each other. Islamic teachings encourage the recognition of private property and respect for individual freedom. Ibn Khaldun highlights that the job of the state is to defend and maintain law and order, to ensure justice, fulfilment of contracts, removal of grievances, fulfilment of needs and compliance with the rules of behaviour. This element gives an impact to the implementation of Shariah audit practices in Islamic banks since Shariah audit can be used as a tool for the institutions, which are the Islamic banks and the state to govern and oversee the overall operations to be in compliance with the Shariah.

#### 4.3.1.4 Role of Wealth

According to Chapra (2008), wealth provides the resources needed for ensuring justice and development, the effective performance of its role by the government, and the well-being of all people. Based on the Muqaddimah the accumulation of wealth is closely related to the economic activities. Wealth does not depend on the existence of gold and silver mines or stars (Muqaddimah: 366; Rosenthal’s translation II.282). Chapra (2008) mentioned that in Ibn Khaldun’s theory wealth is associated with income. If the business activities generate high income, the larger savings and greater investment in tools (Muqaddimah: 360; Rosenthal’s translation: II. 271-2) which will, in turn, contribute to increased development and wealth (Muqaddimah: 360; Rosenthal’s translation: II. 271-2). Further discussion on wealth according to Ibn Khaldun is highlighted by Chapra (2008 p. 843) as follows:

*“And know that wealth does not grow when hoarded and amassed in safes. It rather grows and expands when it is spent for the well-being of the people, for giving them their rights, and for removing their hardships” (Muqaddimah: 306; R: II. 146). This makes “the people better off, strengthens the state, makes the times prosperous, and enhances the prestige [of the state]” (Muqaddimah: 306; R: II. 146). A rise in incomes and wealth contributes to a rise in tax revenues and enables the government to spend more on the people’s well-being. This leads to an expansion in economic opportunities (Muqaddimah: 362; Rosenthal’s translation: II. 275) and greater development, which, in turn, induces a natural rise in population and also the immigration of skilled and unskilled labour and scholars from other places (Muqaddimah: 362-3; Rosenthal’s translation: II. 271-6), thus further strengthening the human and intellectual capital of that society. Such a rise in population boosts the demand for goods and services, and thereby promotes industries (al-sanai), raises incomes, promotes sciences and education (Muqaddimah: 359 and 399-403; Rosenthal’s translation: II. 270 and 346-52), and further accelerates development (Muqaddimah: 363 and 403; Rosenthal’s translation: II: 277 and 351-52).*

Wealth plays important roles in the economic development in the society. In Islamic banking, wealth or income is associated with deposits and investments derived from the customers. Teck Heang et al. (2009) mentioned that the audit expectation gap is harmful to the public, investors and politicians because, in a capitalist economy, the process of wealth creation and political stability depend on heavily upon the confidence in the processes of accountability. Shariah audit plays a major role in mitigating the sources of income and its distribution in Islamic bank operations. Wealth generated from the activities and operations and the activities in the Islamic banking must undergo auditing function to ensure Shariah compliance. It is important to seek how the role of wealth influences the implementation of Shariah audit practices in Malaysia.

#### 4.3.1.5 Role of the Trigger Mechanism

Role of the trigger mechanism means the elements discussed above (political authority (G), beliefs and rules of behaviour or the Shariah (S), people (N), wealth or stock of resources (W), development (g) and justice (j)) may be treated as a dependent variable with the others being considered independent (Chapra, 2008). According to Ibn Khaldun's theory, the decline of a society may not necessarily be the same in all societies. In Muslim societies, the trigger mechanism was the failure of the political authority (G) which, unfortunately, continues in most Muslim countries until the present and has led to the misuse of public resources and their non-availability for the realisation of justice, development and general well-being. Chapra (2008) summarised that the trigger mechanism in other societies may be any of the variables in Ibn Khaldun's model.

From the Shariah audit view, the trigger mechanism could be the weakness of the Shariah compliance system resulting from faulty Shariah audit planning due to the absence of a proper Shariah audit framework by the institutions or the state. It could also be the lack of the human capital expertise in Shariah audit, which leads to the inefficient performance of human resources that leads to the weaknesses of the Shariah compliance system.

The characteristics outlined in Chapra's model can be integrated into the Shariah audit practices. Based on the characteristics discussed above, there is a possible relationship between the variables in ensuring the Shariah compliance aspect in an IFI. Chapra's model based highlights that the role of human beings, the role of development and justice, the role of institutions and state and the role of wealth, can be applied in the development of Shariah audit practices. For the purpose of this research, this thesis used

the characteristics outline by Chapra's model on Ibn Khaldun's theory and further developed the variables into the dimension that fits the Shariah audit practices. This can be seen in the theoretical framework of the thesis that further discussed in the next section.

#### **4.4 THE RELATIONSHIP AMONG AGENCY THEORY, STAKEHOLDER THEORY, IBN KHALDUN'S THEORY WITH AUDIT EXPECTATION GAP IN SHARIAH AUDIT PRACTICES**

SGF (BNM, 2010) highlights the implementation of Shariah audit in the IFIs. This research departs from the SGF (BNM, 2010) model of Shariah audit practices. Shariah audit practices as outlined in the SGF (BNM, 2010) can be related to agency theory regarding its principle and agent basis; and stakeholder theory regarding the parties that related to the operations of the Islamic banks. The SGF (BNM, 2010) should incline towards stakeholder value orientation, where its governance style aims at protecting the wider group of stakeholders. Even though the function of Shariah audit is highlighted in the framework, detailed practice and legal implications are still lacking. The model of agency theory from the Islamic perspectives raises the issue of the design of an efficient audit structure of IFIs within an Islamic paradigm. It is critical to identify characteristics, values, norms and behaviour of agency theory from an Islamic perspective. The idea behind agency theory received criticisms from the previous scholars (Freeman, Wicks, & Parmar, 2004). They claimed that the agency theory provides a short-term perspective and explanation of the purpose of the firm. The scope of agency theory is narrow since it projects the activities of the firm from the perspective of the shareholders only.

However, according to Chapra and Ahmad (2002), they emphasize on the notion of equitably protecting the rights of all stakeholders irrespective of whether they hold equity or not. In addition, Iqbal and Mirakhor, (2004) view that corporate governance model in Islamic economic system is a stakeholder centered model in which the governance style and structures protect the interest and rights of all stakeholders rather than the shareholders per se. Thus, this research shift its view from agency theory to the stakeholder theory. From Islamic perspectives on stakeholder theory, according to Iqbal & Mirakhor (2004) and Iqbal & Molyneux (2005), a stakeholder is defined as the one whose property rights are at stake or risk due to voluntary or involuntary actions of the firm. This implies that the firm is expected to preserve property rights of not only the shareholders but also those who have participated in the process of acquiring or earning the firm's property, and those who could be threatened as a result of the firm's operation (Dusuki, 2007). Stakeholder theory highlights on the benefit of the stakeholders parties to ensure proper check and balance in the nature of interactions between the business and its stakeholder's. The party related to stakeholders are inline with the components highlighted in the Ibn Khaldun's theory.

Chapra's model (2008) on Ibn Khaldun's theory that outlines several important characteristics on the economic development may fits the gap in the agency theory. According to Chapra (2008) based on the Ibn Khaldun's theory, few parties plays important roles in realizing strong economic development such as role of human being (moral, institutional, psychological, political, social and demographic factors), role of development and justice, role of state, role of wealth and role of trigger mechanism. In determining the important roles in realizing strong economic development, Shariah audit functions can be the best mechanism for protecting and resolving problems stemming from the inherent conflicting rights and responsibilities in different fields

specifically in the IFIs. The theory of economic development as addressed by Ibn Khaldun has been widely applied in many areas related to *muamalat* such as tax (Abdul Azim, 2006), Islamic microfinance (Dusuki, 2010; Mihajat & Hoetoro, 2010; Obaidullah & Salma, 2008) and sustainable economic development (M. Umer Chapra, 2006, 2008; Mohammad Tahir Sabit, 2010; Salman, 2006). Thus, it can also be related to discussion on Shariah audit. This is because Ibn Khaldun's theory can be applied in today's corporate and cooperative entities (Mohammad Tahir Sabit, 2010). Therefore, this thesis used the characteristics outline in Chapra's model (2008) on Ibn Khaldun's theory of economic development and further narrowed to fit in the theoretical framework in audit expectation gap Shariah audit practices in the Islamic banks.

#### **4.5 THEORETICAL FRAMEWORK OF AUDIT EXPECTATION GAP IN SHARIAH AUDIT PRACTICES**

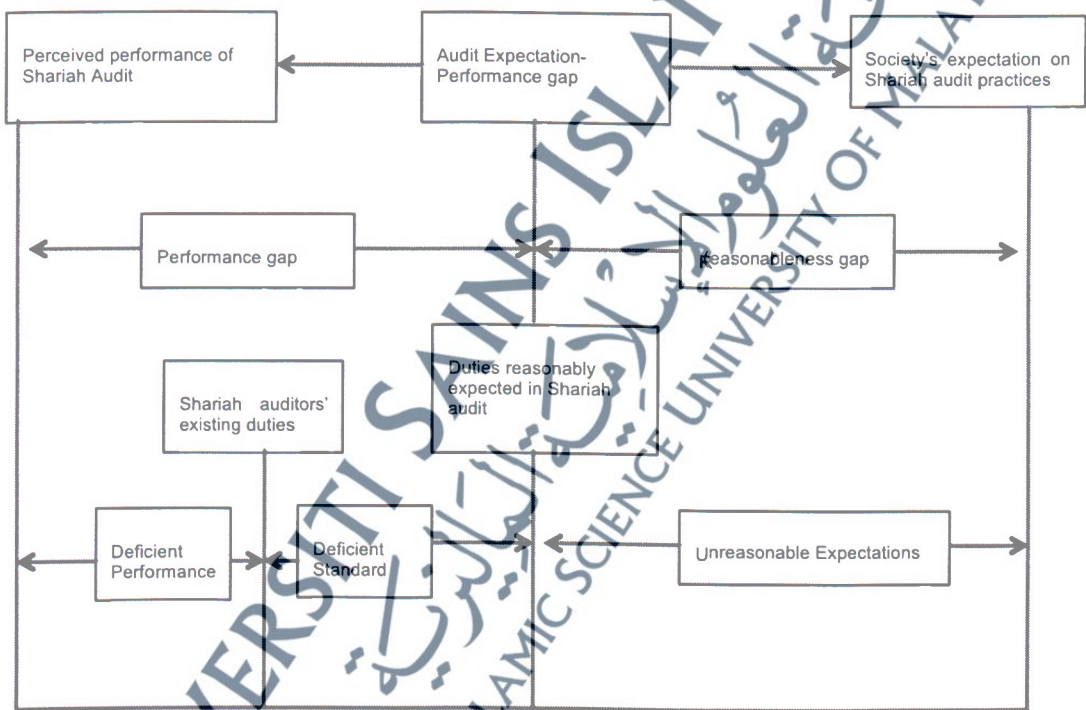
Based on the previous theories discussed in the previous section, the researcher identify the gaps that arise from the theories and further improved the characteristics aspect to fit in the theoretical framework of audit expectation gap in Shariah audit. This study arrives by applying the notable framework well referred in the audit expectation gap introduced by Porter (1993) to the Shariah audit practices. However, the characteristics and variables highlighted in the Porter's (1993) model on audit expectation gap are modified to include the Chapra (2008) characteristics based on Ibn Khaldun's theory and apply it to the Shariah audit practices. Besides identifying the existence of the expectation gap in Shariah audit, this research also aims to determine whether the expectations gap is due to unreasonable expectations on Shariah audit or a deficiency in Shariah audit performance, or weaknesses in policies and regulations

(which in line with Ibn Khaldun's theory on role of institutions and state). The characteristics of Chapra's model on Ibn Khaldun's theory (i.e. role of human being, role of development and justice, role of state and role of wealth) provide the operationalization of Porter's (1993) model on audit expectation-performance gap. In other words from the point of Shariah audit practices in the Islamic banks, role of human beings is referred to the role of Shariah auditors, whereas role of development and justice refers to the Shariah audit functions in the Islamic banks, role of state refers to the role of regulator (BNM) in Shariah compliance aspect and role of wealth refer to process of accumulation of wealth made by the Islamic banks which requires Shariah auditing process to ensure the sources of income.

From the expectation-performance point of view, there are two components to the gap: 'reasonableness gap' and 'performance gap' (Porter, 1993). The 'reasonableness gap' arises when society's expectation of auditors exceeds the duties that can reasonably be expected of auditors, such as reporting to the authorities every single irregularity or fraud detected (Haniffa & Hudaib, 2007; Porter, Simon, & Hatherly, 2003). The 'reasonableness gap' in Shariah audit can be operationalize using Chapra model's on Ibn Khaldun theory on role of human beings (Shariah auditors) and role of development and justice.

The 'performance gap' arises when society's reasonable expectation of auditors' accomplishments is not equivalent to their expectation of auditors' achievement. This result could be due to either 'deficient standards' (the gap between duties reasonably expected of auditors and auditors' existing duties, as defined by the law and professional promulgations) or 'deficient performance' (the gap between the expected standard of performance of auditors' existing duties and auditors' perceived performance). Performance gap due to 'deficient standard' involves comparing the roles and

responsibilities based on legal and professional standards (Teck Heang et al., 2007; Haniffa & Hudaib, 2007; Bui & Porter, 2010; Fadzly & Ahmad, 2004) and through responses from survey and observations. Deficient standards may also arise due to factors in the environment that do not support effective functioning in auditing. The ‘performance gap’ in Shariah audit can be operationalize using Chapra model’s on Ibn Khaldun theory on role of state/regulator (BNM) in Shariah compliance aspect and role of wealth. The theoretical framework of audit expectation gap in Shariah audit practices can be illustrated in the figure below:



**Figure 9: The Theoretical Framework of Audit Expectation Gap in Shariah Audit practices**

Based on the figure above, this research will explore the expectation-performance gap in Shariah audit practices in Islamic banks between the society’s expectations of Shariah audit and its performance as perceived by the society (i.e., Shariah Advisory Council,

Shariah Committee, Shariah officers, Shariah auditors, Internal auditors, external auditors and depositors). Two major components are involved in this study:

1. Reasonableness gap – a gap between what societies expects on the practices of Shariah audit and what it can reasonably be expected to accomplish. (Role of Shariah auditors and role of development and justice)
2. Performance gap – a gap between what societies can reasonably expect practices of Shariah audit to accomplish and what they are perceived to achieve. This may be subdivided into:
  - 2.1 Deficient standards – a gap between the duties which can reasonably be expected of Shariah auditors and Shariah auditors’ existing duties as defined by the Shariah Governance Framework (BNM, 2010) and Islamic Financial Services Act (2014) (Role of regulators)
  - 2.2 Deficient performance – a gap between the expected standard of performance of Shariah auditors’ existing duties and Shariah auditors’ perceived performance, as expected and perceived by society. (Role of wealth)

#### **4.5.1 Reasonableness Gap in Shariah Audit**

As discussed earlier, Porter (1993) detailed the definition of reasonableness gap as a gap between what societies expects on the practices of audit and what it can reasonably be expected to accomplish. This study is looking from the perspectives of Shariah audit in terms of exploring the gap between what societies (i.e. regulators, Shariah committees, Shariah officers, Shariah managers, internal and external auditors and the depositors) expects on the practices of Shariah audit and what it can reasonably

be expected to accomplish.

Kasim et al. (2009), Mulyani & Ibrahim (2008) and Sulaiman (2005) explored, empirically, the gap between “the desired” and “the actual”. The desirable practice may not be similar to the actual practice that takes place. Based on the findings done by Kasim et al. (2009) and Mulyani & Ibrahim (2008) the desired practice of Shariah auditing is to conduct externally, but the result shows that the current practice is done at the internal level only. The studies conducted by Kasim et al. (2009) and Mulyani & Ibrahim (2008) are in line with Wartick and Mahon (1994), Wartick and Wood (1998) and Reichart (2003) that defined expectation gap as inconsistencies between views of ‘what is’ and/or ‘what ought to be. However, Porter (1993) classified this scenario as ‘reasonableness gap’, which was illustrated in her model of the audit expectation-performance gap.

Based on the guideline from the Institute of Internal Auditors Malaysia (IIAM) on the setting up and operation of internal audit departments, this research identifies the reasonableness practice of Shariah audit in the Islamic banks. Since the Shariah audit function in the IFIs is attached to the internal audit department (SGF 2010), thus, it is wise to adapt the critical elements in the Institute of Internal Audit (IIA) guidelines on International Standards for the Professional Practice of Internal Auditing (2010) towards setting up and operation of Shariah audit function in the IFIs. The critical elements of Shariah audit practices that require attention are i) framework of Shariah audit - where to be placed? ii) processes of Shariah audit – what to do? iii) scope of Shariah audit – how much the department has to do? iv) reporting of Shariah audit – when the things have to be done? and v) competency and independence of Shariah auditors – who have to do it?

Determining the reasonableness gap in the Shariah audit will involve a series of

interview session or open-ended questionnaires to the Shariah advisory council (regulators), Shariah committees, Shariah officers, internal and external auditors and the depositors on their expectations towards the practice of Shariah audit. For this purpose, a series of research hypotheses are developed to complement the study.

#### **4.5.1.1 Framework Of Shariah Audit – ‘Where’ To Be Placed**

It is important to allocate the chain of command or the hierarchical system of Shariah audit function in an IFI. Shariah audit function should be placed high in the institutions to ensure the independence and objectivity are not jeopardised. According to SGF (2010), Shariah audit is one of the functions performed by the internal auditors. This shows that Shariah audit function shall be attached to the internal audit department of an IFI. However, there are few arguments concerning the framework of Shariah audit whether to be done by the internal auditor or external auditor. Kasim (2009) argues that the framework for Shariah audit should differ from the conventional audit. Al-Khudairi (1990) suggested a general framework for Shariah compliance and divided the process into three levels. The first level begins with the selection of the institution’s officers and their training to ensure their understanding of the nature of Islamic financial transactions and products. The second level is the internal audit. The third level is the external audit, which includes the ShC. This committee should be an independent external body. The author divides the functions of the ShC into four:

- 1) Corrective (*‘ilajiyah*) function: to review the existing products offered to ensure that all transactions are in accordance with the Shariah;
- 2) Preventive (*wiqa’iyah*) function: to review everyday operations of the bank to prevent the possible occurrence of noncompliance;

- 3) Innovative (*ibtikariyyah*) function: to develop new products to cater to the needs of the customers;
- 4) Directive (*tawjihiyah*) function: to provide advice and suggestions for the betterment of the bank's operation;

Referring to the framework outlined by Al-Khudairi (1990), the Shariah compliance function (Shariah audit) is performed by the internal auditors and external party. According to the SGF (BNM, 2010), the Shariah audit function shall be done by the internal auditors of the IFIs. This creates an issue whether it shall be done by the internal auditor or external party. In addition, Chapra and Habib (2002) suggested that chartered audit firms should acquire the necessary knowledge to undertake Shariah audits. They suggested that Shariah audit shall be performed by the external parties to ensure greater compliance in Shariah requirements. Abdul Rahman (2009) argues that it is not certain that switching to external Shariah audit would bring tangible guarantees of Shariah compliance, since internal auditors are generally more familiar with the record systems, policies and procedures of the institution and can provide quick responses to managers. The result could be more detailed and exhaustive in an internal Shariah audit. Moreover, according to Liu et al. (1997) the objectives of internal audit have been increased to cover social, management, operational and ad hoc audits which also capable to perform other new area in internal audit. The internal auditor not only act as the key of corporate governance as well as internal consultancy (Stewart & Subramaniam, 2008) but the role has been expanded to perform other area such as Shariah audit in ensuring the operations of the IFI are Shariah-compliant. Therefore, the placement of Shariah audit function in the internal audit department shall be given a high profile from the start. It is key to determine the IFI's adherence to the Shariah principles.

Other issues related to the framework are the difference between Shariah audit and Shariah review. As introduced in the SGF (BNM, 2010), Shariah review function refers to regular assessment on Shariah compliance in the activities and operations of the IFI by a qualified Shariah officer. The function involves the examination and evaluation of the IFI's level of compliance to the Shariah, remedial rectification measures to resolve non-compliances and control mechanism to avoid recurrences. The scope shall cover the IFI's overall business operations, including the end-to-end product development process, which starts from product structuring to product offering. The review process shall cover, but is not limited to, the following:

- 1) Planning the review programme which includes the objectives, scope, reporting, rectification and follow-up actions followed by the execution of the programme;
- 2) Documentation of the processes involved in the review;
- 3) Communicating the outcome of the review and highlighting any non-compliances to the Shariah Committee and the management; and
- 4) Rectifying any instances of noncompliance with the Shariah to prevent such events from recurring.

AAOIFI GSIFI No. 2 defines Shariah review as the main purpose for the requirement of Shariah review for IFIs is to make certain that all the activities carried out by the IFIs are truly in compliance with the Shariah rules and regulations as reflected in the fatwas, rulings and guidelines issued by the SSB. AAOIFI has recommended several procedures to be followed by the Shariah reviewers in performing the Shariah review on IFIs. The process involved in Shariah review are planning on the review procedures, executing review procedures, preparation and review of working paper as well as procedures in documenting conclusions and preparation of the Shariah review report.

In the first procedure of planning and designing the Shariah review as according to AAOIFI GSIFI No. 2, the Shariah reviewer is required to draw up a detailed plan whereby information such as the operations of the IFI including its products, size, locations, branches and subsidiaries should be stated in the plan to ensure that the Shariah review can be conducted and completed systematically and in a timely manner. In addition to the above, the list of all fatwas, rulings and guidelines to be obtained should also be disclosed in the plan. Therefore, it is crucial for the Shariah reviewer to be familiar with the structure, operations, transactions and other related activities of the IFI and its group of subsidiaries to enable the Shariah reviewer to provide accurate Shariah opinions on the overall operations of the IFI. The planning procedure will also assist the Shariah reviewer to ascertain whether the transactions and products of the IFIs which should be approved by the SSB are carried out according to the relevant requirements.

The next stage of the Shariah review involves execution of the planned procedures. In this stage, the Shariah reviewer would be required to obtain the understanding of the IFI's Management on their awareness, commitment and compliance control procedures for adherence to Shariah rulings. Thereafter, the Shariah review to be conducted can be considered to some extent similar to the work of an auditor whereby the Shariah reviewer shall go through, among others, the contracts, agreements and transactions entered into by the IFI to see whether they are in compliance with Shariah rules and principles. Apart from reviewing the above, the Shariah review also covers the review of other information or reports of the IFI such as circulars, minutes of meetings, operating and financial reports, policies and procedures.

All the review procedures undertaken by the Shariah reviewer are required to be documented in proper working papers. Upon completion of the Shariah review, any

findings would be discussed with the management of the IFI for further action to be taken, if necessary.

The final procedure in the Shariah review as suggested by AAOIFI would be the documentation on the conclusions of the review and preparation of the Shariah review report to the shareholders that will be read at the IFI's annual general meeting and published in the annual report.

#### *4.5.1.2 Processes in Shariah Audit– 'What' To Do*

In performing the Shariah audit, it is essential to plan and identify the processes before performing the audit. All level of staff within the IFIs shall know the functions and be aware of the terms of reference under which department has been authorised to operate. According to Abdul Rahman (2010), the first challenge to undertake Shariah audit is to establish audit evidence. Shariah audit evidence can be defined as any information used by the auditor to determine whether the information being audited is stated in accordance with established criteria for Shariah assurance purposes (Abdul Rahman, 2010). The International Standard on Auditing (ISA 500, 2009) on Audit Evidence also mentioned the importance to establish audit evidence which is when designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence (Ref: Para. A26-A33). In the context of performing a Shariah audit, the auditor must ensure that the evidence collected must be related to Shariah assurance. If not, the evidence will be considered irrelevant and the objective of the audit will not be achieved.

Sultan (2007) and Abdul Rahman (2008) mentioned the importance to establishing a Shariah audit programme in performing Shariah audit processes. Shariah audit programme is the list of audit procedures. It shall consist comprehensive audit objectives and audit techniques to meet Shariah requirement standards in the auditing

processes. Auditors have to set the audit objectives in relation to the conduct of Shariah audit. The objectives of the Shariah audit must cover two basic areas; attestation to compliance with Shariah principles and compliance with laws and regulations. Sultan (2007) and Abdul Rahman (2010) also argued that there are at least three phases of the Shariah audit which is:

- I. Planning;
- II. Examination;
- III. Reporting.

At the planning stage, the auditors need to understand the business of the IFIs including the nature of contracts used for different types of Islamic financial services. Then, the Shariah auditors need to identify the appropriate techniques, resources and scope to develop the audit programme. The audit program will then identify the key activities to be undertaken, the objectives of each activity and techniques to be used including sampling technique to achieve each the audit objectives. The techniques that can be utilised include examination of papers, interviewing, benchmarking, surveys, case studies, flow-charting and others.

During the examination stage, the shariah auditors shall determine the most suitable audit techniques to gather the required evidence both in quality and quantity. The audit techniques chosen shall enable reasonable conclusions to be drawn and to ensure the adherence to the Shariah requirements. Certain aspects of the audit fieldwork will require sampling techniques. In certain circumstances a more detailed examination of the documentations would be necessary whether sampling methodology is used or not. Of immense importance during the fieldwork are the working papers and audit records. The main purpose of retaining working papers is to furnish a systematic record

of work carried out during the audit, and they also represent a record of information and facts obtained to support the findings and conclusions.

The final stage, the reporting stage, embodies deliverables from the audit exercise. This includes preparing the Shariah audit report, which is the communication of the auditor's findings to users.

#### **4.5.1.3 Audit Scope In Shariah Audit – 'How' Much The Department Has To Do**

The scope of Shariah audit in the Shariah Governance Framework Model (BNM, 2010) covers all aspects of the IFI's business operations and activities, including:

- I. Audit of financial statements of the IFI;
- II. Compliance audit on organisational structure, people, process and information technology application systems; and
- III. Review of adequacy of the Shariah governance process.

The discussions on the audit scope are derived from the SGF issued by BNM (2010). However, it is proposed that the audit scope shall cover areas other than those stipulated in the SGF such as Shariah audit shall also be conducted on risk management, marketing strategy, and *Takaful* operations. The components in the audit scope shall also reflect the overall operations of the IFI. However, since the SGF is silent on the sub-components of the audit scope, it is the responsibility of the auditor of an IFI to determine according to their niche. Since SGF (BNM, 2010) is silent on the detailed scope of the Shariah audit, this research proposes an extension to the scope of Shariah audit in the SGF (BNM, 2010).

Auditors have to perform an audit of financial statements to verify that the management of IFIs performs its fiduciary duties to maximise the value of stakeholders out of the entrusted resources. The existing accounting system of IFIs should be capable

of measuring, recognising, recording and reporting the accounting transactions carried out. However, at present audit is not performed for the measurement, recognition, recording and reporting of Shariah issues in the financial statements. IFIs' mandate is to operate according to the Shariah principles, giving rise to Shariah issues that are relevant at every spectrum of activities and operations of IFIs, thus the need to cater for the Shariah issues in the financial statements.

The auditors shall test the financing, risk management and hedging mechanism, investment, recognition of income and expenses and income/profit distribution including zakat computation and payment. The activities and operations of IFIs must be audited so that the activities provide benefit to the public and to the investors, depositors and shareholders of the IFIs as well as they do not bring harms to the public (Surah Al-Qasas, Verse 77), where Allah says:

*And seek the abode of the Hereafter with the wealth that Allah has given you, and do not forget your part in this world, and do favours (to others) the way Allah has favoured you, and do not seek to cause turmoil in the earth; indeed, Allah does not like the mischievous.*

Regarding the scope of Shariah audit on compliance audit, Shariah audit should cover the audit of processes and procedures of information technology (IT), organisation structure and human resources (HR). Shariah audit of IT must cover the Transaction Processing System (TPS), Accounting Information System (AIS), and any other systems adopted by IFIs so that they comply with the Shariah. As computer technology has advanced, most of the IFIs have become increasingly dependent on computerised information systems to carry out their operations and to process, maintain, and report essential information. This result in the reliability of computerised data and the systems that process, maintain and report these data are a major concern to audits.

The auditors of the IFI shall evaluate the reliability of computer generated data supporting financial statements and overall operations. The outcomes derived from the system must reflect the overall operations including the product, people and organisational structure of the IFI are Shariah-compliant.

In addition, the auditors shall examine the adequacy of controls in information systems and related operations to ensure system effectiveness. Shariah audit of IT is the process of collecting and evaluating evidence to determine whether a computer system has been designed to maintain data integrity, safeguard assets, allows organisational goals to be achieved effectively, and uses resources efficiently. Data integrity relates to the accuracy and completeness of information as well as to its validity in accordance with the norms. For example, the IT system that the IFI used in recording the transactions shall be different from the system that they used in recording the conventional transactions. This is to ensure that the output derived from the system reflects the Shariah applications in the IFI. If the systems adopted by the IFIs are the same for both Islamic and conventional applications, the auditor must highlight whether there is a difference in the output and does it affects the Shariah applications on a specific product or transactions.

Shariah audit on organisational structure is performed to ensure that the structure allows for effective Shariah governance in the IFI. Each IFI must have its human resource policy. From a Shariah point of view, human resource policy must address issues such as the dress code of the employees, *surau* for Muslims, male staff working hours during *jumaat* prayer, employee training on products offered by IFIs and any other human resources issues identified by the Shariah Committee. The Shariah Committee of an IFI must ensure that the policy is being followed by the Shariah audit,

and regular check must be properly addressed. In the event of Shariah non-compliance, it must be rectified immediately.

In terms of the review of the adequacy of Shariah governance process, the Shariah auditors must ensure that the roles, functions and reporting channels are in place in the Islamic banks. For example, the findings from the Shariah audit shall be communicated to the Audit Committee and Shariah Committee of the IFIs. The roles and functions of the Board of Directors, the Shariah Committee, the Audit Committee and the management must be in place in the IFI. The auditors shall make an observation on this matter during the audit. They shall also provide recommendations to enhance the Shariah governance process in the IFIs.

According to the SGF, the IFI shall establish formal reporting channels to ensure that the reporting on Shariah matters is carried out effectively and on a timely manner. In performing Shariah audit on reviewing the adequacy of the Shariah governance process, the auditor shall collect evidence on the reporting process in an IFI. This is to ensure adherence to the SGF issued by BNM. In this regard, the Shariah Committee shall functionally report to the Board of Directors. The Shariah review function shall report concurrently to the Shariah Committee and management, and the Shariah audit findings shall be reported to the Audit Committee and Shariah Committee. All Shariah noncompliance events are to be reported to the board of the IFI and the Bank. The findings on Shariah noncompliance events shall be documented by the IFI for the auditors to review during the audit period.

#### ***4.5.1.4 Reporting and Audit Timing – ‘When’ Shariah Audit Have To Be Reported***

The evidence collected in performing the Shariah audit by the Shariah auditors shall be analysed and critically assessed to draw a conclusion that the overall operations

of IFIs are in compliance with the Shariah law and regulations. The audit report is a basis of communications from the auditor to the shareholders on the attestation and assurance of the financial statements of the IFI. Reports differ in nature, but all must inform readers of the degree of correspondence between information and established criteria. It is proposed that the audit report shall reflect not only on the financial statements, but the overall operations of the IFI. Even though reporting on the Shariah aspect has been covered through the Shariah Committee report, but it is important for the overall operations to be assured by external parties. In this scenario, the external parties are the external auditors. Thus, the auditor's report should contain a clear written expression of opinion not only on the financial statements but that the overall operations of the IFI comply with Shariah principles. Even though reporting on the Shariah has been covered through the Shariah Committee report, it is important that the overall operations have been assured through the Shariah audit report. However, presently the result and findings from the Shariah audit in the Islamic banks are not shared and communicated to the public.

The ability to identify Shariah audit findings, communicate and determine the audit conclusions is one of the skills that add the most value to a management system audit. After the final conclusions have been drawn, it is necessary to discuss audit follow-up activities if there is a Shariah nonconformity or Shariah noncompliance. For a third-party external audit, the follow-up might be the responsibility of the Shariah department or internal audit department and might not involve external auditors. For internal audits, the same auditor or an auditor from the same audit programme department might conduct a follow-up audit to verify the Shariah noncompliance was corrected. This will reduce the risk of Shariah noncompliance operations in the IFI and

increase the reliance of the stakeholders on the performance and conformity to Shariah principles.

#### ***4.5.1.5 Competency And Independence – ‘Who’ Have To Do It***

Independence in auditing means taking an unbiased viewpoint in the performance of audit tests, the evaluation of the results and the issuance of the audit report (Arens et al., 2008) so that management can place full reliance on audit findings and recommendations (Pickett, 2000). The Institute of Internal Auditors Malaysia (IIAM) offers the following definition of internal auditing:

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

According to the Malaysian Institute of Accountants (MIA) By-Law B-1.4 (2006), independence requires both (i) independence of mind and (ii) independence in appearance. Independence in fact (or actual independence) can be defined as the auditor's state of mind and his/ her ability to maintain a proper attitude in the planning of his audit programme, the performance of his verification work, and the preparation of his report (Mautz & Sharaf, 1961). On the other hand, independence in appearance (or perceived independence) refers to the public's or others' perceptions of the auditor's independence. To be seen to be independent, an auditor should be able to demonstrate that there is no threat to his or her independence such that an outsider would not doubt the auditor's objectivity (Arens et al., 2008; Messier & Boh, 2002). Independence is a critical issue in auditing since it is the cornerstone of the profession (Mautz & Sharaf, 1961).

The SGF (BNM, 2010) defines the responsibility of conducting Shariah audit lies in the hands of the internal audit unit. This signals that the responsibility of the internal auditor has expanded. The internal auditor not only acts as the key to corporate governance as well as internal consultancy (Stewart & Subramaniam, 2009) but the role has been expanded to perform the Shariah audit ensuring that the operations of the IFI are Shariah-compliant. This leads to the issue of independence and objectivity, the competence of the auditor and auditor's performance in performing the new tasks outlined in the SGF (BNM, 2010). This triggers the perceptions of the stakeholders on the strength of the internal audit function in performing the Shariah audit. Kassim (2009) showed that a gap exists in the practice of the Shariah audit. There is gap between the 'desirable' and the 'current' practice of Shariah auditing in the IFIs in Malaysia. The desirable practice is to conduct Shariah auditing externally, but the result shows that the current practice is performed at the internal level only. She argued that there are gaps in Shariah audit regarding the framework, scope, qualifications and independence. She also mentioned that from her findings, most of the IFI's internal auditors are not qualified in performing Shariah audit task since they do not have a Shariah background.

According to IIA (2010) on the professional practice framework of internal auditing, the internal auditor should have independence in terms of organisational status and personal objectivity which permits the proper performance of his duties (paragraphs 11 to 14). This research suggests that the internal auditor of an IFI shall maintain its independence especially with the Shariah Committee since the results and audit findings are tabled to the Audit Committee and Shariah Committee.

Independence is achieved through the organisational status of internal audit and the objectivity of internal auditors. The outcome from the Shariah audit function tabled to the Shariah Committee may involve independence issues since the Shariah

Committee of the IFI is responsible for decisions, views and opinions related to Shariah matters. The Shariah Committee is also expected to perform an oversight role on Shariah matters related to the institution's business operations and activities. This is achieved through the Shariah review and the Shariah audit functions. Independence is a fundamental concept in auditing, as auditors cannot audit or examine their work (Kassim, 2009). This applies to the Shariah Committee of the IFI since they are responsible for the endorsement of Shariah policies and procedures and at the same time conducting Shariah review and Shariah audit on the overall operations. The board of the IFIs bears the ultimate responsibility and accountability for the overall governance of the IFI, and the board is expected to rely on the Shariah Committee on all Shariah decisions, views and opinions relating to the business of the IFI. This triggers question on the line of communications and reporting as the Board is expected to rely on the Shariah Committee works. If the Board is expected to depend on the Shariah Committee works, the issue of independence in reporting will arise. Due to that, it is crucial to investigate the independence factor in performing Shariah audit.

Flint (1988) stated that audit competence requires both knowledge and skill, which is the product of education, training and experiences. In a standard issued by International Federation of Accountants (IFAC) on International Education Standard (IES 8) Competence Requirements for Audit Professional, outlines that auditors must have the formal education (knowledge) relevant to audit (IES 2), professional skills (IES 3) and be able to apply the professional values, ethics and attitudes (IES 4) to different contexts and organisations. Based on these definitions, it is clear that auditor competence is determined by considering a set of relevant attributes such as knowledge, skill and attitudes. Thus, the internal auditors attached to the IFI must not only have auditing skills but also need to have a Shariah background specifically in *Fiqh*'

*Muamalat*. This is to ensure proper Shariah audit has been conducted, and that the overall operations of IFIs are Shariah compliant.

According to IIAM (2010), the internal audit unit should be appropriately staffed regarding numbers, grades, qualifications and experience, having regard to its responsibilities and objectives. The internal auditor should be adequately trained to fulfil all his responsibilities (paragraphs 15 to 26). The effectiveness of internal audit depends substantially on the quality, training and experience of its staff. The aim should be to appoint staff with the appropriate accounting and Shariah background, personal qualities and potential. Thereafter, steps should be taken to provide the necessary experience, training and continuing professional education. Abdul Rahman Abdul Rahim (2010) argues that one of the challenges in implementing the Shariah audit would be to produce competent and independent Shariah auditors. He suggested that the education and training programme on Shariah audit should equip the Shariah auditor with two basic knowledge i.e. specialised Shariah knowledge as applied in Islamic banking and finance, and accounting and auditing knowledge and skills.

Based on the requirements highlighted in the internal audit guideline, this study arrive at the hypotheses development to gather empirical evidence on audit expectation gap in Shariah audit practices. The list of hypotheses development are as follows:

*H<sub>1</sub>*: There is an expectation gap among the respondents (regulators, Shariah committee, internal auditors, external auditors, Shariah auditors, Shariah officers and the depositors) on the practice of Shariah audit in the Islamic banks.

*H<sub>1a</sub>*: There is an expectation gap among the respondents on the **framework** of Shariah audit in the Islamic banks.

*H<sub>1b</sub>*: There is an expectation gap among the respondents on the **scope** of Shariah audit in the Islamic banks.

*H<sub>1c</sub>*: There is an expectation gap among the respondents on the **competency** of Shariah audit in the Islamic banks.

*H<sub>1d</sub>*: There is an expectation gap among the respondents on the **processes** of Shariah audit in the Islamic banks.

*H<sub>1e</sub>*: There is an expectation gap among the respondents on the **reporting** of Shariah audit in the Islamic banks.

*H<sub>1f</sub>*: There is an expectation gap among the respondents on the **independence** of Shariah audit in the Islamic banks.

#### 4.5.2 PERFORMANCE GAP IN SHARIAH AUDIT PRACTICES

According to Porter (1993), the 'performance gap' arises when society's reasonable expectation of auditors' accomplishments not equivalent to their expectation of auditors' achievement. This result could be due to either 'deficient standards' (the gap between duties reasonably expected of auditors and auditors' existing duties, as defined by the law and professional promulgations) or 'deficient performance' (the gap between the expected standard of performance of auditors' existing duties and auditors' perceived performance). Performance gap due to 'deficient standard' involves comparing the roles and responsibilities based on legal and professional standards (Teck Heang et al., 2007; Haniffa & Hudaib, 2007; Bui & Porter, 2010; Fadzly & Ahmad, 2004) and through responses from survey and observations. Deficient standards may also arise due to factors in the environment that do not support the effective functioning in auditing.

One of the causes of the performance gap in relation to the auditors' role and responsibilities is due to deficiency in the standards, a situation that arises when auditors are not able to fulfil the roles and responsibilities expected by the public because they are not clearly defined or are not included in the legal pronouncements (Haniffa &

Hudaib, 2007; Teck Heang, 2008; Muneeza & Hassan, 2011; Porter, 1993; Zaidi, 2007). In Shariah audit practices the duties and responsibilities of a Shariah auditor are not clearly defined in the SGF (BNM, 2010) or IFSA (2013). However, the implementation of Shariah audit function in the IFIs is highlighted in the SGF (BNM, 2010) and IFSA (2013). Due to that, this research chooses the guideline outlined in the SGF (BNM, 2010) and IFSA (2013) on Shariah audit function and additional responsibilities of Shariah auditors that perceived by the public in order to determine the expectation gap due to deficient standard.

‘Deficient performance’ is defined as the gap between the expected standard of performance of auditors’ existing duties and auditors’ perceived performance. For the purpose of this research, the deficient performance of the Shariah audit is measured based on the fulfillment of the existing duties of the Shariah auditors and perceived performance in the Islamic banks.

The second phase of the research will involve a series of questionnaires and hypotheses to measure the gap among the respondents. The hypotheses development for deficient standards is based on regulator’s policy on the Shariah audit function. Performance gap may exist when the Shariah auditors are not able to fulfil the role and responsibilities expected by the public due to they are not clearly defined in the regulator’s policy. SGF (BNM, 2010) and IFSA (2013) describe the function of Shariah audit in the IFIs but the specific roles and responsibilities of Shariah auditors are not properly addressed. Thus, this study expects an expectations gap among the respondents concerning the current performance of responsibilities as prescribed by the regulator’s policy. In addition to the responsibilities in Shariah audit as prescribed by the regulators, the measurement of performance of responsibilities in Shariah audit are also derived from the input during the interview sessions with the respondents in Part A. Among the

identified responsibilities in the Shariah audit are:

- a) Shariah auditors are responsible for compliance to the Shariah rulings in the IFIs (*bakhs, tafif, 'uqud, khiyanah, israf, tanajush, speculation and gharar*).
- b) Shariah auditors are responsible for internal control System for Shariah compliance in the IFIs.
- c) Shariah auditors are responsible to attest and provide Shariah assurance on the overall operations in the IFIs.

These are the three main areas highlighted by the respondents during the interview sessions. Hypotheses are developed to test the reasonable responsibilities of Shariah auditors as outlined above for empirical evidence. Hence the list of hypotheses is as follows:

**H<sub>2</sub>:** *There is an expectation gap among the respondents (regulators, Shariah committee, internal auditors, external auditors, Shariah auditors, Shariah officers and the depositors) in relation to the Shariah audit responsibility.*

**H<sub>2a</sub>:** *There is an expectation gap among the respondents concerning Shariah audit responsibility as prescribed by regulators BNM.*

**H<sub>2b</sub>:** *There is an expectation gap among the respondents concerning Shariah audit responsibility on Shariah rulings (*bakhs, tafif, 'uqud, khiyanah, israf, tanajush, speculation and gharar*).*

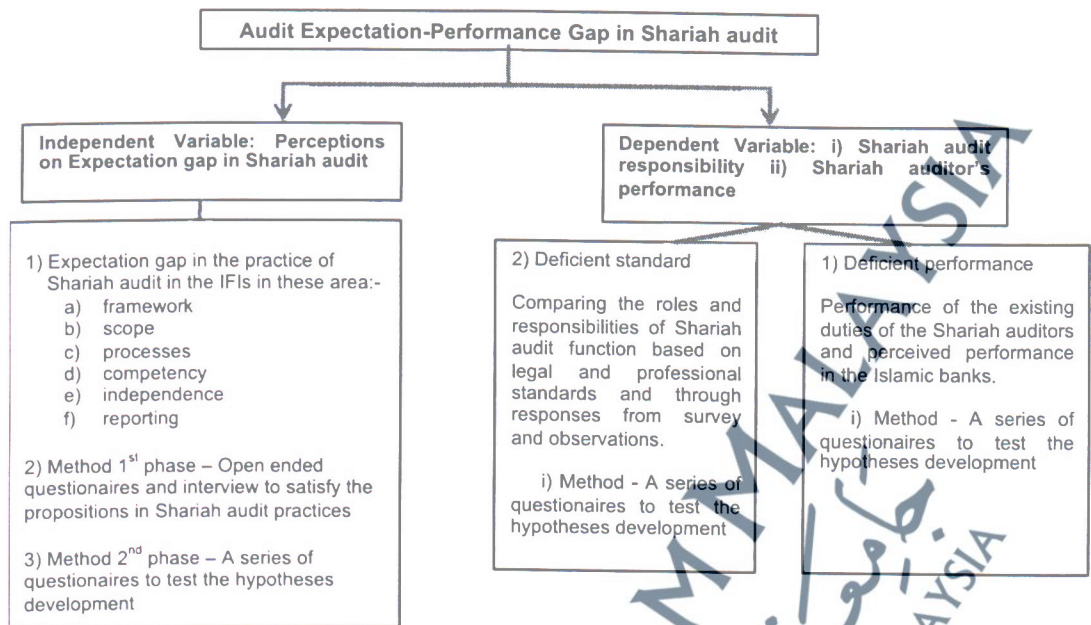
**H<sub>2c</sub>:** *There is an expectation gap among the respondents concerning Shariah audit responsibility to attest and provide Shariah assurance in the Islamic banks.*

Another area highlighted in the second phase is on the 'deficient performance' in Shariah audit. As discussed previously, 'deficient performance' is defined as the gap

between the expected standard of performance of auditors' existing duties and auditors' perceived performance. The development of the hypotheses are based on the performance of the existing duties of the Shariah auditors and perceived performance in the Islamic banks. The hypothesis is:

**H<sub>3</sub>:** *There is an expectation gap among the respondents (regulators, Shariah committee, internal auditors, external auditors, Shariah auditors, Shariah officers and the depositors) on Shariah auditor's performance in Islamic banks.*

The items involved in measuring the Shariah auditor's performance are gathered from the input during the interview session and existing duties of the internal auditors in Islamic banks. Among the assessment of the performance are i) providing useful service to the stakeholders, ii) reporting truthfully, iii) detecting errors and irregularities pertaining to Shariah iv) acting independently v) communicating effectively, vi) prescribing remedies in the event of Shariah noncompliance, vii) preventing errors and irregularities pertaining to Shariah viii) coping with Shariah risk and uncertainty in the transactions ix) predicting the future in the event of Shariah litigation x) enforcing Shariah legal requirements xi) forming correct judgements in Shariah audit findings and xii) coping with professional rules and Shariah rules. In addition, among the assessment for Shariah audit responsibilities are a) Shariah auditors are responsible towards the the outside financiers (i.e. capital contributor, mudharib), b) Shariah auditors should have a clear understanding on the business activities of the IFIs to allow better scoping audit exercise, c) Shariah auditor should develop a comprehensive internal Shariah audit programme d) Shariah auditor should make references to relevant sources including the SAC's published rulings, the SCs decision and, fatwas guidelines e) Shariah audit should be conducted on periodical basis. The overall conceptual framework of the study is illustrated in the diagram below:



**Figure 10: Overall Framework of Audit Expectation-Performance Gap in Shariah Audit practices**

#### 4.5.3 FACTORS AFFECTING THE AUDIT EXPECTATIONS GAP IN SHARIAH AUDIT PRACTICES

The third phase is the factors affecting audit expectations gap in Shariah audit practices on Shariah audit responsibility and Shariah auditor's performance. Based on Figure 10, the independent variable or the factors involved in determining the audit expectations gap in Shariah audit practices is framework, scope, processes, competency, independence and reporting. Shariah audit responsibility and Shariah auditor's performance are identified, as the dependent variables for the study. The factors should be empirically tested to narrow the gap that exists in the Shariah audit practices. The hypotheses development for this phase is as follows:

**H4:** *Framework is positively related to the Shariah audit responsibility and Shariah auditor's performance in Islamic banks.*

**H5:** *Independence is positively related to the Shariah audit responsibility and Shariah auditor's performance in Islamic banks.*

**H6:** *Competency is positively related to the Shariah audit responsibility and Shariah auditor's performance in Islamic banks.*

**H7:** *Reporting is positively related to the Shariah audit responsibility and Shariah auditor's performance in Islamic banks.*

**H8:** *Scope is positively related to the Shariah audit responsibility and Shariah auditor's performance in Islamic banks.*

**H9:** *Processes is positively related to the Shariah audit responsibility and Shariah auditor's performance in Islamic banks.*

#### 4.6 CHAPTER SUMMARY

This chapter discussed the theories that related to Shariah audit. It departed from the SGF (BNM, 2010) on the practice of Shariah audit function, definition, objectives and scope. Next, the study relates the practice of Shariah audit functions to the agency theory and stakeholder theory. Regarding Islamic perspectives, the study also visited the Ibn Khaldun's theory and blend the Shariah audit practices with the idea and concept pointed out by Chapra (2008). Finally, this Chapter proposed its theoretical framework using Porter's model (1993) on the audit expectation-performance gap in Shariah audit practices. The summarized hypotheses development are as follows:

**Table 6: List of Hypotheses**

<b>List of Hypotheses Development</b>	
<b>First Phase:</b> Interview on Shariah audit practices	<b>Framework:</b> i) Shariah audit framework different from Shariah Review Framework and existing audit framework. ii) The external Shariah audit is necessary to complement the present practices (Internal Shariah audit) and to increase the independence and transparency in the Islamic Banks.
	<b>Processes:</b> Shariah audit processes should cover Shariah audit evidence, Shariah audit programme and Shariah audit planning
	<b>Scope:</b> Shariah audit scope should cover a wide area and not only limited to scope addressed in the Shariah Governance Framework issued by BNM
	<b>Reporting:</b> Shariah audit report should differ from Shariah Committee report
	<b>Independence:</b> Shariah audit should be a separate unit in Islamic Banks rather than attach to internal audit department to ensure independence.
	<b>Competency:</b> Shariah auditor/internal auditor in the Islamic banks who performs Shariah audit function should have the accounting and Shariah qualification to achieve competency level
<b>Second Phase - Part A:</b> Expectation gap on Shariah audit practices in the Islamic banks	<p><i>H<sub>1</sub>: There is an expectation gap among the respondents (regulators, Shariah committee, internal auditors, external auditors, Shariah auditors, Shariah officers and the depositors) on the practice of Shariah audit in the Islamic banks.</i></p> <p><i>H<sub>1a</sub>: There is an expectation gap among the respondents on the framework of Shariah audit in the Islamic banks.</i></p> <p><i>H<sub>1b</sub>: There is an expectation gap among the respondents on the scope of Shariah audit in the Islamic banks.</i></p> <p><i>H<sub>1c</sub>: There is an expectation gap among the respondents on the competency of Shariah audit in the Islamic banks.</i></p> <p><i>H<sub>1d</sub>: There is an expectation gap among the respondents on the processes of Shariah audit in the Islamic banks.</i></p> <p><i>H<sub>1e</sub>: There is an expectation gap among the respondents on the reporting of Shariah audit in the Islamic banks.</i></p>

	<i>H1f: There is an expectation gap among the respondents on the independence of Shariah audit in the Islamic banks.</i>
<b>Second Phase – Part B:</b> i) Expectation gap in Shariah audit responsibility	<p><i>H2: There is an expectation gap among the respondents (regulators, Shariah committee, internal auditors, external auditors, Shariah auditors, Shariah officers and the depositors) in relation to the Shariah audit responsibility.</i></p> <p><i>H2a: There is an expectation gap among the respondents concerning Shariah audit responsibility as prescribed by regulators BNM.</i></p> <p><i>H2b: There is an expectation gap among the respondents concerning Shariah audit responsibility on Shariah rulings (bakhs, tafsis, 'uqud, khiyanah, israf, tanajush, speculation and gharar).</i></p> <p><i>H2c: There is an expectation gap among the respondents concerning Shariah audit responsibility to attest and provide Shariah assurance in the Islamic banks.</i></p>
<b>Second Phase – Part B:</b> ii) Expectation gap in Shariah auditor's Performance	<i>H3: There is an expectation gap among the respondents (regulators, Shariah committee, internal auditors, external auditors, Shariah auditors, Shariah officers and the depositors) on Shariah auditor's performance in Islamic banks.</i>
<b>Third Phase:</b> Factors affecting audit expectation gap on: a) Shariah audit responsibility b) Shariah auditor's performance	<p><i>H4: Framework is positively related to the Shariah audit responsibility and Shariah auditor's performance in Islamic banks.</i></p> <p><i>H5: Independence is positively related to the Shariah audit responsibility and Shariah auditor's performance in Islamic banks.</i></p> <p><i>H6: Competency is positively related to the Shariah audit responsibility and Shariah auditor's performance in Islamic banks.</i></p> <p><i>H7: Reporting is positively related to the Shariah audit responsibility and Shariah auditor's performance in Islamic banks.</i></p> <p><i>H8: Scope is positively related to the Shariah audit responsibility and Shariah auditor's performance in Islamic banks.</i></p> <p><i>H9: Processes is positively related to the Shariah audit responsibility and Shariah auditor's performance in Islamic banks.</i></p>