

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Malaysia aspires to become the leading international Islamic financial centre. Currently, the Islamic finance industry in Malaysia covers Islamic banking, Takaful and capital market. The regulatory regime governing IFIs varies across countries. International organisations have been established to set standards that would strengthen and eventually harmonise prudential regulations as they apply to IFIs (El-Hawary, Grais, & Iqbal, 2007). This includes regulations on the practice of Shariah audit. Shariah audit has emerged as an important mechanism in ensuring Shariah compliance keeps pace with the rapid development of IFIs.

Shariah audit practices strengthen Shariah compliance and enhance the integrity of the IFIs. It emerged to cater for the different nature and characteristics of Islamic banking practices. Many Islamic banking scholars, identified the nature of Islamic banking should be distinct from the conventional banks. Islamic banking and finance should differ from conventional banking practices in terms of: i) striving for a just, fair and balanced society as envisioned by Islamic economics, ii) constructed upon the principle of brotherhood and cooperation, which calls for a system of equity-sharing, risk-sharing and stake-taking, iii) characterised by ethical norms and social commitments as a system grounded in the ethical and moral framework of the Shariah community, iv) oriented and entrepreneur-friendly, emphasising productivity and the physical expansion of economic production and services, and v) operates within limits that ensure stability in the value of money and that curtail destabilising speculation (Chapra & Ahmed, 2002; Dusuki, 2011; Iqbal & Mirakhor, 2007).

Given the above elements, there is a need for the IFIs to practice Shariah audit. There should be a party that oversees the activities and operations of the Islamic banks to ensure they are in line with the objectives of Islamic economics. This is critical for the legitimacy of IFIs and its absence it is a serious loophole in the Islamic financial system (Abdul Rahman, 2009).

Numerous Shariah auditing guidelines have been set by domestic authorities such as Bank Negara Malaysia (BNM) and international organisations such as the Accounting, Auditing of Islamic Financial Institutions (AAOIFI) standards in Bahrain. As at 2009, AAOIFI standards consists of a total of twenty four Islamic accounting standards, twenty one Shariah standards, five auditing standards, four governance standards and two codes of ethics. AAOIFI uses the term 'Internal Shariah Review (ISR)' as opposed to Shariah audit used by BNM in the Shariah Governance Framework. The ISR guidelines in the AAOIFI standards are largely consistent with the Shariah Governance Framework (SGF). According to AAOIFI, the ISR unit is responsible to perform audit in the IFIs, whereas in SGF (BNM, 2010) Shariah audit function is responsible to perform check and balances of Shariah compliance in the IFIs. The SGF issued by BNM in 2010 address the implementation of the Shariah audit function in IFIs. The SGF is a set of organisational arrangements through which IFIs ensure effective oversight, responsibility and accountability of the board of directors, management and Shariah committee. The framework serves as a guide towards ensuring an operating environment that is compliant with Shariah principles at all times. In measuring the IFIs compliance to the Shariah, SGF requires regular internal Shariah reviews and Shariah audits, supported by an appropriate risk management process and research capability. International Shariah scholars and bankers believe that given the

systemic approach of Malaysia in developing its Islamic finance sector, the SGF is the best of its kind and could become a blueprint for other countries to follow.

IFIs including Islamic banks and Takaful companies operate within the limits of Shariah. To ensure that the operations of IFIs do not contradict with Shariah, the IFIs need Shariah Committee (SC) to function as advisors or supervisors of IFIs' activities. The responsibilities of the SC include evaluating and approving Islamic financial products, prepare a draft of Shariah opinions, prepare contracts in collaboration with legal advisor of the bank, etc. However, so far SC members are not in the position to carry out a comprehensive Shariah audit on the operations of IFIs due to their restricted scope of work. According to Ibrahim (2012), the members of the SC are pre-eminently qualified for their role of issuing fatwas on the Shariah permissibility of a financial product, but they are not qualified auditors because they are not trained in the collecting and evaluating of evidence. Further, their advisory role in developing products would conflict with their auditing role, as this constitutes a self-review threat, according to the International Federation of Accountant's (IFAC) code of ethics.

Despite IFIs having rules and regulations and accounting standards and guidelines, many improvement are needed to ensure Shariah auditing is regulated by proper standards or framework that can lead to harmonisation among the IFIs. Presently in Malaysia, there is neither framework nor standard that specifically addresses Shariah audit practices that can be referred to by the practitioners in implementing the Shariah audit function in the IFIs. This is supported by Ibrahim (2012) that the Shariah auditing profession needs a host of standards, both for the established criteria (such as IFRS in financial statement auditing) and audit methodology (such as the corresponding international auditing, review and assurance standards).

In the following section, this research will look into motivation of the study. The research problems are outlined in Section 1.3 while the research questions and objectives are provided in Sections 1.4 and 1.5. The significance of the study is discussed in Section 1.6 while Section 1.7 outlines the scope of the study. In the last section 1.8 is the overall organisation of the thesis.

1.2 MOTIVATION OF THE STUDY

The motivation of the study is to ensure Shariah compliance issues are properly addressed since Shariah noncompliance is a risk to all IFIs. This can be done through developing proper guidance on Shariah audit practices regarding framework, scope, independence, competency, processes, reporting, responsibilities and performance. With the expanding global Islamic banking and finance industry, there is a need for developing professional Shariah auditing practices. In addition, the failure of external auditors and Shariah Supervisory Board members to conduct a holistic Shariah audit (Najeeb and Ibrahim, 2014) motivates this research to identify gaps in current practices in Shariah audit. According to Sultan (2007), Shariah noncompliance risks may occur in products, the technology supporting the operations, operational processes, the people involved, documentations and contracts, policies and procedures, and other activities that require adherence to Shariah principles. According to Chik (2011), Shariah auditing should not address worldly corporate governance practices only, but a religious obligation on the IFIs and Shariah auditors (*muhtasib/mudaqqiq syar'ie*).

In current practice, Shariah committees and SSBs hired by various Islamic finance institutions constitute the only party responsible for determining the Shariah-compliant status of financial instruments. Their front-end role is to issue opinions on the legality of financial products offered by the Islamic banking, Takaful, mutual funds,

and wealth management business (Rosly, 2010). As the validity of Islamic contracts is established on the basis of Shariah compliance, Shariah scholars at the supervisory level have issued a set of Shariah rules and principles that must be fully observed by the contracting parties in their respective business engagement and contracts. However, according to Ibrahim (2008), the technical process of determining Shariah legitimacy of financial instruments tends to overlook the financial reporting aspects of the transactions. There is a growing branch of literature which calls for a review of the auditing practices of IFIs as the existing conventional auditors fail to perform a Shariah audit of an institution while the Shariah advisors do not conduct an ex-post review of the product once they have issued their opinions ex-ante. Thus, the key motivation of this paper is to provide evidence on the current practice of Shariah audit functions and the existence of an audit expectation gap among the practitioners involved in Shariah auditing with regards to the framework, scope, independence, competency, processes, reporting, responsibilities and Shariah auditor's performance in the Islamic banks.

1.3 RESEARCH PROBLEM

Shariah audit has a key importance as there is a growing awareness among IFIs that they should contribute towards achieving the objectives of the Maqasid Shariah. There is a need to have a regular independent Shariah audit in IFIs as people are now experiencing a movement along a continuum from a society that trusts everything and audits nothing to a society that trusts nothing and audits everything. The concept of Shariah auditing should be extended to the activities relating to among others, the system, the products, the employees, the environment and the society. There is a need to develop useful Shariah audit practices to ensure the effectiveness of the goals of Shariah compliance in IFIs, which in turn can contribute positively to the ummah.

According to Abdul Rahman (2011), Shariah Committee of the IFIs normally expressed their opinions on the Shariah compliance of the products and services offered (ex-ante compliance). He also argued that a comprehensive and well-guided audit of the Shariah legal contracts, documentations and operations have not been adequately conducted. The ex-post compliance stage is absent in practice. Without a Shariah audit function, this scenario creates a functional gap of Shariah compliance in the Islamic financial system. From the stakeholder's point of view, it will create an expectation gap in Shariah audit practices in the IFIs. Shariah audit, in theory, should enhance the shareholders' value and confidence of the stakeholders of the IFIs. If stakeholders (i.e. customers, depositors, etc.) are suspicious of Shariah compliance, it would adversely affect the integrity of Islamic finance (Abdul Rahman, 2011; Atiqah, 2009).

Audit expectation gap exists for several reasons. Pierce and Kilcommins (1996), Boyd et al. (2001) and McEnroe and Martens (2001), argue that the gap exists due to misinterpretations and misunderstanding of the meaning of auditing by the users. These studies suggest that the users do not understand the audit functions and the role of auditors. Consequently, they have unrealistic expectations of auditors. Humphrey et al. (1993) and Porter and Gowthorpe (2004); for example, argued the gap exists due to a deficiency in an auditor's performance and auditing standards. Porter (1993) established deficient performance, deficient standards and unreasonable expectations as the components of the audit expectations gap. However, a recent empirical study conducted by Porter and Gowthorpe (2004) showed that these elements have changed over time although the perceptions of pessimism as to the audit functions have not been eliminated. The audit expectations gap is a prominent issue in the conventional audit. Previous studies show that the audit expectations gap centres on several issues. The most notable are the auditor's roles and responsibilities (Porter, 1993; Fazdly and

Ahmad, 2004; Dixon et al., 2006; Teck Heang and et al., 2008), the nature and meaning of audit report messages (Monroe and Woodliff, 1994; Gay et al., 1998) and audit independence (Sweeney, 1997; Lin and Chen, 2004; Alleyne et al., 2006). Humphrey (1997) classified the issues on the audit expectations gap into audit assurance, audit reporting, audit independence and audit regulation. Research on the audit expectations gap in the Shariah audit practice has received no attention at all attention by researchers.

To date, a limited number of studies have been conducted on Shariah audit practices in Malaysia. One of the early empirical studies has been initiated by Hood and Bucheery (1999) on audit expectation gap between financial and religious (Islamic) auditors in Bahrain. Hood & Bucheery (1999) further argued that religious audit in Bahrain seems to complement the financial audit by external auditors. Nevertheless, they questioned whether or not religious auditors have a set of religious statements to audit as compared to financial statement audited by financial auditors. They found that a financial audit expectation gap does exist in Bahrain but not for religious auditors. They also found that financial auditors and religious auditors in Bahrain seem unaware of the tasks performed by each. Hood & Bucheery (1999) presumed that this finding might be due to respondents' lack of understanding on the subject of the religious audit. Kassim et al. (2009) examined the expectations and the actual practice of Shariah audit function in IFIs in Malaysia. The study surveys different groups of respondents involved directly or indirectly with the process of Shariah compliance/auditing in IFIs. Based on their study, there is a gap between the 'desirable' and the 'current' practice of Shariah auditing in the IFIs in Malaysia. Kassim et al. (2009) classified the gap into framework, scope, qualifications and independence. These four components differ from previous studies on audit expectation gap.

Grais and Pellegrini (2006) mentioned that the Islamic banking industry lacks supervision and monitoring, oversight, auditing and management of risks. These are closely related to the competency level of Shariah auditors. Any risks resulting from auditor's incompetency will expose Islamic banks to potential losses (Othman and Ameer, 2015). Losses to the Islamic banks like in the case of Dubai Islamic banks in 1998, signals the importance of identifying and monitoring the gaps that exist in Shariah audit practices. Mulyani (2007) found that the academics, audit practitioners and Shariah scholars in Malaysia, agreed strongly with the creation of a new Shariah audit discipline with a separate regulatory framework. This Shariah audit should be conducted by a new group of professionals termed Shariah auditors. In addition, Yahya and Mahzan (2012) found that the practice of Shariah audit is still at the development stage and requires further improvement. Thus, there is a need to increase the understanding of Shariah auditing among internal auditors, enhance the Shariah knowledge of internal auditors, standardise the Shariah audit framework and provide general guidelines to design audit programmes for Shariah auditing. Abdul Rahman (2011) also suggested the need for establishing Shariah audit evidence, Shariah audit education, Shariah audit programmes and procedures, and reporting resulting from the Shariah audit findings. Training on Shariah audit practices must be undertaken among regulatory authorities, IFI staff and external auditors should reach a uniform level of understanding of what constitutes Shariah audit (Sultan, 2007; Abdul Rahman, 2008).

Based on the previous studies and given the current scenario, there is no doubting the need to identify the existence of an expectation gap in Shariah audit practices due to different views and opinion by the scholars, practitioners and stakeholders in the practice of Shariah audit. It is crucial to get feedback from the regulators, practitioners and the stakeholders on what would be the best practices in

Shariah audit and analyse their expectations to identify gaps in the implementation of the Shariah audit function based on the SGF (BNM, 2010) and Islamic Financial Services Act (IFSA, 2013). It is important to identify the gaps that exist in the practice of Shariah audit since its implementation requires improvement (Othman and Ameer, 2015). Through the identification of the factors that contribute to the expectation gap in Shariah audit practices, steps will be taken as an initiative to narrow the gaps. This is to enhance and harmonise the practice of Shariah audit in IFIs.

1.4 RESEARCH QUESTIONS

The aim of this study is to identify whether there is expectation gap in the Shariah audit practices in IFIs. The specific research questions of this study are as follows:

- 1) What are the perceptions of the internal auditors (Shariah auditors), regulators (BNM), Shariah committee, Shariah officers', external auditors and depositors concerning the Shariah audit practices in the Islamic banks in Malaysia?
- 2) Does the expectations-performance gap exist between internal auditors (Shariah auditors), regulators (BNM), Shariah committee, Shariah officers, external auditors and depositors concerning the Shariah audit practices in the Islamic banks in Malaysia?
- 3) What are the factors that affect the expectation gap on performance in Shariah audit (i.e.; Shariah audit responsibility and Shariah auditor's performance)?

1.5 RESEARCH OBJECTIVES

Based on the research questions, this study will focus on the following research objectives:

- 1) To examine the perceptions of the internal auditors (Shariah auditors), regulators (BNM), Shariah committee, Shariah officers, external auditors and depositors concerning the Shariah audit practices in the Islamic banks in Malaysia.
- 2) To determine the existence of expectations-performance gap between internal auditors (Shariah auditors), regulators (BNM), Shariah committee, Shariah officers external auditors and depositors concerning the Shariah audit practices in the Islamic banks in Malaysia.
- 3) To identify factors that affect the expectation gap on performance in Shariah audit (i.e.; Shariah audit responsibility and Shariah auditor's performance).

1.6 SIGNIFICANCE OF THE STUDY

The development of Shariah audit practices is essential to complement the Shariah compliance mechanisms already in place and practised internally in the IFIs. This study is significant due to the following reasons. The outcome of this research will benefit relevant parties such as the regulators, stakeholders, and practitioners in the IFIs and the auditing profession. For the regulators such as BNM and the Securities Commissions this research will benefit them regarding monitoring the operations of the IFIs and its adherence to the Shariah compliance issues. Regulators will benefit through

the determination of the factors that contribute to the audit expectations gap in Shariah audit and may take action to narrow the gaps. It will also minimise the blame made by the practitioners (Muneeza and Hassan, 2010; Sultan, 2007) of not implementing standards or a framework regarding Shariah audit practices.

Secondly, identifying the expectation gaps in Shariah audit practices through framework, scope, independence, competency, processes, reporting, responsibility and Shariah auditor's performance should enhance the shareholders' value and confidence of the stakeholders of the IFIs. This will increase the level of trust of the stakeholders that the activities and operations of the IFIs are Shariah-compliant. Also, Shariah audit contributes towards managing the risks of the IFI and within the grander scheme of things contributes to the growth of the industry and the economy by providing adequate disclosure for the stakeholders to make informed decisions (Sultan, 2007). It will also bring confidence to the public and the financial markets on the credibility of Islamic banking operations.

Thirdly, the IFIs will benefit from this research by minimising its litigation on Shariah noncompliance through narrowing the gap that exists in the Shariah audit practices based on the factors related to the expectation gap in Shariah audit practices. Shariah non-compliant is a severe risk factor in Islamic banking and finance. Proper check and balance on the activities and operations of the IFIs through Shariah audit practices will minimise such losses.

In addition to the contribution to the literature, the findings of this research have implications for auditing practices. In ensuring proper checks and balances and transparency in the operations of IFIs, the stakeholders will better understand the needs of having a Shariah audit which might urge the regulators to expand the scope of Shariah audit such as having it as an external audit. The Shariah audit conducted by an external

Shariah auditor will increase the assurance of reporting. Auditing firms need to train their auditors to meet the demand for external Shariah auditors somewhere in the future. This is in line with the study proposed by Najeeb and Ibrahim (2014) on the professionalising role of the Shariah auditor. The study argues that a new breed of Islamic accountants and auditors are required who are trained in both conventional accounting and auditing principles as well as Shariah. Universities and other institutions such IBFIM, Associations of Islamic Banking Institutions Malaysia (AIBIM) or INCEIF must also take the challenge to produce graduates and certified Shariah auditors to cater for future global demand. In the future, hopefully, Malaysia will become one of the hubs in producing certified Shariah auditors together with guides, standards, processes, systems and manuals for conducting Shariah audit.

1.7 SCOPE OF THE STUDY

This study explores the presence (or absence) of the audit expectations gap in Shariah audit practices. It investigates the perceptions of the Shariah Committee, internal auditors, external auditors, depositors, Shariah officers and regulators (BNM) on the framework, scope, independence, competency, processes, reporting, responsibility and Shariah auditor's performance in Shariah audit practices. This study aims to address as many possible questions at a broader level, rather than in depth, on the particular audit concepts to give insight to the industry of the present state of the Shariah audit functions and its overall audit process.

The absence of standard framework in Shariah audit coupled with lack of standardization in the Shariah audit practices, makes it difficult for Islamic banks to implement the assurance process. Hence, engaged scholarship activities related with

this key audience is embedded within every stage of research process. The specific direct key audience in the bank are the Shariah compliance department, internal auditors or internal Shariah auditors. Then, the idea of developing the strength of those functions within the bank through identifying gaps in the Shariah audit practices is to improve the integrity of the Islamic banks. This study covers Islamic banks only and do not cover other IFIs such as takaful industry due to the rapid growth in the Islamic banking sector in Malaysia. Malaysian Takaful industry is still in the stage of infancy but slowly contributes to the growth in the Islamic finance in Malaysia. According to Ahmad Rizlan (2016), who is also Chief Executive Officer of Etiqa Takaful Bhd, Malaysia's biggest Islamic insurer, that growth prospects in Takaful still remain positive just by the virtue of the fact that the Takaful base is smaller relative to overall insurance industry. However, Islamic banking sector experienced a rapid growth in Malaysia since the banking market share of Shariah-compliant assets under management in Malaysia is about 25 per cent (Parker, 2016). Therefore, this study focused on Malaysian Islamic banking industry to crystalize the existence of expectation gaps in the Shariah audit practices in a specific industry. This is also to avoid bias respondent during data collection that may arise due to different sector.

The study is limited to Islamic Banks in Malaysia only and did not cover other developing countries since Malaysia's Islamic Banks have better growth stability and quality than others in the Asean countries (The Star, 2016). Also, this is due to the time constraints in collecting primary data if it involves other countries Islamic Banks.

Porter's Model in audit expectation gap is used in the research due to the limited theoretical support on the Shariah audit practices. Porter's model specifically categorized the existence of audit expectation gap into the reasonableness gap or performance gap in audit. Such model is significant to the Shariah audit practices since

at current there are no theoretical framework that specifically categorized expectation gap into specific area (i.e. reasonableness gap or performance gap). The categorization may assist the regulators and policy makers to specifically identify the gap that exists in the Shariah audit practices. Thus, through the identification and categorizing of expectation gap, it will narrow the gap in Shariah audit practices in Malaysian Islamic banks that leads to better Shariah compliance assurance in the industry. This will also boost the stakeholder's confidence towards the Islamic banking industry.

1.8 ORGANISATION OF THE THESIS

Firstly, this chapter presented and discussed the background of the study. It explained why Shariah audit is vital to the existing practices in the Islamic banks. Additionally, the statement of the problem was discussed, as this study is set to discover the expectation gaps in Shariah audit practices. This was followed by the identification of factors that leads to expectation gaps in Shariah audit. Secondly, next chapter in the thesis discuss on the auditing from the perspectives of Islam. The chapter emphasised the importance of the Shariah audit in ensuring proper Shariah governance. It adds an important assurance to all stakeholders that the operations of IFIs are Shariah compliant and contribute towards realising the Maqasid Shariah in society. Thirdly, the chapter of the thesis highlight on the literature review on audit expectation gap and its relationship with Shariah audit practices. Given the lack of research on this topic in the context of Malaysia based on the literature, this research is an important contribution to academia and industry and is set to constitute an important foundation for further studies in this field. Fourthly, this thesis discuss on the theoretical framework used in the study. The theory involve in this study were agency theory, stakeholder theory and Ibn Khaldun's

theory. Later the chapter highlights on the relationship among agency theory, stakeholder theory, Ibn Khaldun's theory with audit expectation gap in Shariah audit practices. This thesis further develop the hypotheses using Porter's model (1993) on audit expectation gap to the Shariah audit practices. Fifthly, the thesis discuss on the methodology used to achieve the objectives which is the mixed method. Sixthly, the thesis highlights on the findings and analysis of the study. Finally, in the last chapter, the thesis summarize the overall findings and provide suggestions and solutions for future study.

