

SHARIAH GOVERNANCE AND AUDIT PRACTICES IN ISLAMIC CO-OPERATIVES: AN AUDIT EXPECTATION-PERFORMANCE GAP ANALYSIS

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Abstract

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This study focuses on the inclusion of Shariah governance and audit best practices in Islamic co-operatives in Malaysia. The development of Shariah governance and audit is essential to complement the Shariah compliance mechanisms already in place and practiced internally within these Islamic co-operatives. Strong regulations, frameworks, and guidelines are needed to uphold Shariah compliance practices. The Delphi method was used as the study's methodology, involving a series of discussions with industry practitioners in Islamic co-operatives. Based on the findings, there is an existing expectation-performance gap in regulations, frameworks, and guidelines; independence and competency; and Shariah audit scope in governing Shariah compliance principles in Islamic co-operatives. This is crucial because well-developed regulations, frameworks, and guidelines in Shariah governance and audit will increase stakeholders' trust that the activities and operations of Islamic co-operatives are Shariah-compliant. Additionally, providing a standardized framework will help manage risks in Islamic co-operatives and, in the broader context, contribute to the industry's and the economy's growth by offering stakeholders adequate information to make informed decisions.

Keywords: Shariah Audit, Shariah Governance, Islamic Co-Operatives, Expectation Gap, Performance Gap

Authors' individual contribution: Conceptualization — S.S.; Investigation — N.A.M.S.; Writing — M.I.H.K.; Supervision — Z.S. and M.M.H.; Project Administration — N.Z. and W.A.M.

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1. INTRODUCTION

Islamic co-operatives in Malaysia are regulated by the Malaysian Co-operative Societies Commission (*Suruhanjaya Koperasi Malaysia*, SKM). The development of Shariah governance and audit is essential to complement the Shariah compliance mechanisms already in place and practiced internally within Islamic co-operatives. The implementation of Shariah governance and audit is required to ensure that institutions conduct their business in adherence to Shariah.

It is crucial for Islamic co-operatives registered under SKM to further strengthen Shariah governance and audit. Good governance is important for any institution, including co-operatives, to achieve its goals. Indonesia and Malaysia have facilitated their domestic co-operative movements by issuing relevant laws, guidelines, and Shariah governance frameworks to provide clear roles for board management, the establishment of Shariah committees, and other aspects to enhance the credibility and soundness of co-operatives (Shafii et al., 2019). Findings indicating a lack of Shariah expertise and competency among Shariah auditors in co-operatives create an urgency for regulators to develop Shariah governance frameworks and perform audit functions in microfinance institutions.

According to the *Policy Document on Shariah Governance* (Bank Negara Malaysia [BNM], 2019), Shariah governance is integral to the stability of the Islamic financial system. Institutionalizing a sound Shariah governance framework strengthens public confidence in the integrity, management, and business operations of Islamic financial institutions. The main Shariah control functions highlighted by BNM (2019) are Shariah risk, Shariah review, and Shariah audit. Shariah audit functions play an important role in improving good governance and should be applied in the Islamic co-operative sector, where Shariah governance and audit functions must be in place to ensure Shariah compliance.

The index of top 100 co-operatives in Malaysia (SKM, 2023a) reveals that among the top 100 co-operatives, the financial services sector continues to dominate with 46 credit co-operatives. Additionally, there are about 553 co-operatives offering both financing and credit functions, amounting to 48.82 billion Malaysian ringgit (RM) (SKM, 2023b). Beyond the significant contribution of the financial services sector in terms of financing disbursed, this sector, represented by two co-operative banks and 551 credit co-operatives, also holds substantial assets amounting to RM 145.57 billion and contributes nearly 87.6 percent of the total sector turnover (SKM, 2023b).

In Malaysia, most Shariah-based co-operatives, also known as Islamic co-operatives, offer Shariah-compliant products and services, including Islamic microfinancing and *ar-rahnu* activities. The development of Shariah compliance in Islamic co-operatives is driven by the rapid growth of the financial industry and Islamic banking (Hassan et al., 2018). Since these co-operatives are Islamic in nature, their business activities and financial products must be Shariah-compliant.

The main objective of Shariah governance practices is to enhance the integrity of Islamic co-operatives and increase the level of Shariah

compliance. Thus, Islamic co-operatives engaged in Shariah-based activities are required to implement Shariah governance in their operations. This includes Shariah compliance responsibilities starting from the co-operative board level, through management, to Shariah officers in developing an environment based on Islamic principles and ensuring Shariah compliance (Samad & Shafii, 2021). Additionally, monitoring and regulation by authorities such as SKM are crucial for fulfilling the Shariah compliance ecosystem in Malaysian Islamic co-operatives.

However, several issues and challenges have been identified in the implementation of Shariah governance in Islamic co-operatives. These include establishing Shariah committee functions not only at the regulatory level but also within individual co-operatives. The absence of other Shariah functions, such as Shariah review and Shariah audit, has also been noted. Moreover, a lack of Shariah knowledge and expertise among these Islamic co-operatives further contributes to the challenges in implementing effective Shariah governance practices to ensure Shariah compliance (Mahmud Sabri et al., 2023; Salleh et al., 2022).

Based on these arguments, this study aims to explore the expectation-performance gap in Shariah governance and audit practices in Islamic co-operatives, comparing the expectations of co-operative members with the performance as perceived by practitioners. The Malaysian context was chosen for several reasons. Firstly, Malaysia is recognized as a global leader in the Islamic finance industry, including Islamic co-operatives (Hasan et al., 2020). For instance, the Islamic Finance Country Index (IFCI) 2023 shows that Malaysia ranks among the top three countries most advanced in Islamic finance and has maintained its position since 2011 (Cambridge Institute of Islamic Finance [CIIF], 2023). Secondly, in terms of Islamic assets, including those owned by Islamic co-operatives, Malaysia ranks third with US\$666 billion. The same report ranks Malaysia first in terms of Islamic funds outstanding, including those by Islamic co-operatives, with US\$624 billion (Mohamed & Taitoon, 2023). Thus, focusing on the Malaysian context will provide significant insights and knowledge for readers worldwide.

The structure of this paper is as follows: Section 2 focuses on the background of Shariah governance and audit practices in Islamic co-operatives in Malaysia. Section 3 explains the methodology used in this research. Section 4 presents the research findings and discussions on the expectation-performance gap in regulation, framework and guidelines; independence and competency; and Shariah audit scope in governing Shariah compliance principles in Islamic co-operatives. Finally, Section 5 provides a summary and discusses the implications of the findings in the conclusion section.

2. LITERATURE REVIEW

Due to the successful implementation of Shariah governance and assurance within Islamic financial institutions, especially in Malaysia, SKM continues to make efforts to strengthen Islamic co-operatives' adherence to Shariah rules and principles

(Kamaruddin, Salleh, et al., 2024). SKM has established the *GP28: Garis Panduan Tadbir Urus Syariah* (SKM, 2015) as a guideline to assist and further strengthen Shariah compliance activities in the co-operative sector (Surkery & Yaacob, 2019).

According to Shafii et al. (2019), Shariah governance and audit in the co-operative sector are important because they help people understand the Islamic financial system, which differs from the conventional approach. The objective of Shariah governance is to ensure that Shariah policies, systems, and processes comply with Shariah (Shafii et al., 2019). This aligns with the objective of GP28, which is to regulate co-operatives conducting Shariah-compliant activities, including the establishment of Shariah committees and Shariah governance within co-operatives. It is a proactive initiative in line with the development of the Islamic financial system, which is evolving to meet increasingly complex consumer and business needs. GP28 provides Shariah compliance guidance that will strengthen public confidence in the credibility of the Islamic *muamalat* system, especially in the co-operative sector.

Shah and Sharif (2018) discuss the importance of Shariah governance, noting that a transparent

Shariah governance framework will not only boost an organization's value but also help it achieve the best outcomes. Implementing an effective and transparent Shariah governance framework will increase Islamic co-operatives' value and allow it to achieve the best results. Conversely, organizations with poor Shariah corporate governance are more likely to fail due to a loss of Shariah compliance value in every product, activity, and organizational policy. Islamic co-operatives need to strengthen their governance to improve the institution's image (Mahmud Sabri et al., 2023).

GP28 focuses on Shariah governance that complements GP27, which provides guidance on conventional governance. According to GP28, implementing Shariah compliance in Islamic co-operatives is the responsibility of each component, including: 1) the co-operative board; 2) the Shariah committee; 3) co-operative management; and 4) the internal audit committee. These four functions are responsible for ensuring that the operations of Islamic co-operatives are in line with Shariah rules. Table 1 describes the roles of each Shariah organ function.

Table 1. Roles of Shariah governance organs in Islamic co-operatives

<i>Component</i>	<i>Roles</i>
Co-operatives board	<ul style="list-style-type: none"> To monitor the performance of the Shariah committee. To be responsible for the overall Shariah governance compliance of the co-operative based on the advice of the Shariah committee. To ensure effective communication within the organization. To establish a suitable mechanism to carry out the responsibilities, including oversight and other governance-related tasks. To assure the Shariah committee understands their fiduciary responsibility.
Shariah committee	<ul style="list-style-type: none"> To identify the issues of concern and propose preventive and corrective measures, if necessary. To be aware of and responsible for all the decisions, views and opinions relating to Shariah matters. To perform the roles of supervision on Shariah related to the business operations and activities of the co-operative. To report directly to the board of co-operatives.
Co-operative management	<ul style="list-style-type: none"> To implement the decisions made by the Shariah committee. To establish Shariah-compliant culture in the co-operative. To ensure the policies and the procedures of the Shariah can be accessed at any time. To identify and refer any Shariah issues to the Shariah committee for its decision. To submit promptly complete and accurate information to the Shariah committee and to be transparent about any area that requires clarification by the Shariah committee. To allocate resources and a sufficient workforce to support Shariah governance. To provide education and continuous training programs to the board and Shariah committee.
Internal audit committee	<ul style="list-style-type: none"> To ensure a robust, effective internal control and risk management system. To monitor the implementation of recommendations, comments or opinions issued by the Shariah committee. To investigate any matter as directed by the Shariah committee. To review the adequacy of the Shariah governance process. To investigate and inform the Shariah committee of any suspicious transactions. To ensure the management adheres to the policies and procedures regarding the Shariah matters as decided upon by the Shariah committee. To inform the Shariah committee and board of any inconsistencies that occur in the administration, financial management and activities of the co-operative.

Source: SKM (2015).

Co-operative members, the Shariah committee, internal audit, and management are all involved in the development of Shariah governance in co-operatives, as mentioned in the guideline. GP28 is a valuable initiative since it provides guidance to co-operatives, addressing Shariah aspects in three critical areas: 1) banking products, credit, financing, and *ar-rahnu*; 2) the Shariah committee; and 3) Shariah governance (Surkery & Yaacob, 2019). Co-operatives under SKM that conduct financing and *ar-rahnu* can refer to the guidelines and restructure their products accordingly. Similarly, Hassan et al.

(2018) highlight that most co-operatives have started to follow the Shariah governance guideline GP28 as a reference point. The SKM guidelines are the primary source of reference for Malaysian co-operatives and are critical for developing and launching new products within co-operatives.

In contrast, Surkery and Yaacob (2019) argue that some elements need to be added to make GP28 more comprehensive in terms of Shariah compliance. SKM highlights the functions and responsibilities of the Shariah committee, management, and internal auditors in GP28.

The board has ultimate authority and responsibility for overall governance. All Shariah-related decisions and views must be responsive and accountable to the Shariah committee. The board must rely on the Shariah committee for all co-operative business decisions and viewpoints related to Shariah. On the other hand, the internal audit committee must alert the Shariah committee and the board if any inconsistencies occur in management, finance, or operations (Salleh et al., 2022).

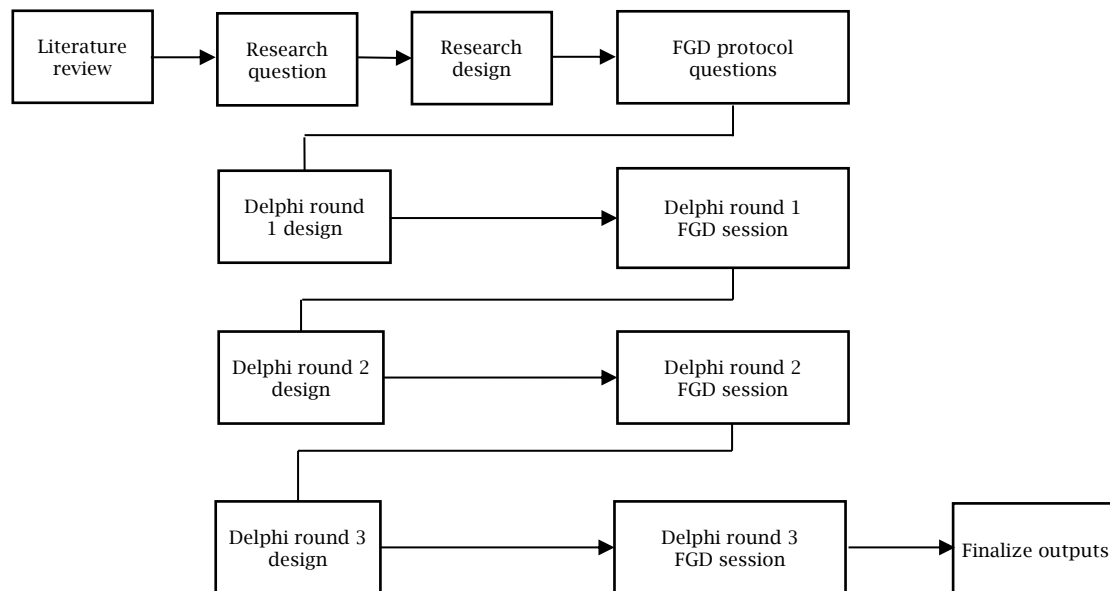
3. METHODOLOGY

This study uses the Delphi method, which reviews and gathers inputs and feedback through a series of focus group discussions (FGD). Among the benefits of focus group discussions is that they reveal individual perspectives and human experiences that may not be addressed or evaluated by quantitative techniques. Additionally, focus group discussions allow researchers to hear respondents' feedback in

their own words and voices. Furthermore, researchers have the opportunity to explore issues in greater depth as they arise during the discussion.

The sample for this study includes Shariah audit experts, regulators, external auditors, internal auditors, Shariah officers from co-operatives, and researchers in Shariah audit. Experts should be knowledgeable not only in auditing but also in Islamic financial contracts within the co-operative sector. There are no specific recommendations regarding the number of participants needed to construct a representative sample for the Delphi technique. The number generally varies between eight and 20 participants but can also reach several hundred (Cadorin et al., 2017). For this study, three external auditors, six co-operative members, and two regulators from SKM participated in the series of focus group discussions. Therefore, the sample is considered adequate and representative of the Delphi technique.

Figure 1. Delphi technique process



Source: Wantanakomol and Silpcharu (2020).

Figure 1 highlights the overall process of the Delphi technique in gathering inputs and data from a series of focus group discussions. This research adopts a qualitative approach, utilizing the Delphi method to ensure robustness in data collection. To gather insights from experts in Shariah audit, the study conducts a series of focus group discussions aimed at validating the components related to the expectation gap in Shariah governance and audit practices. The Delphi technique is regarded as a robust methodology for rigorously querying experts and stakeholders. Enhancing the rigor of this approach will increase the confidence researchers have in utilizing the results in subsequent studies, allowing stakeholders to make informed decisions based on the information gathered through this technique (de Oliveira et al., 2024; Wantanakomol & Silpcharu, 2020).

In addition, data were gathered based on the expectation-performance gap theory by Bui and

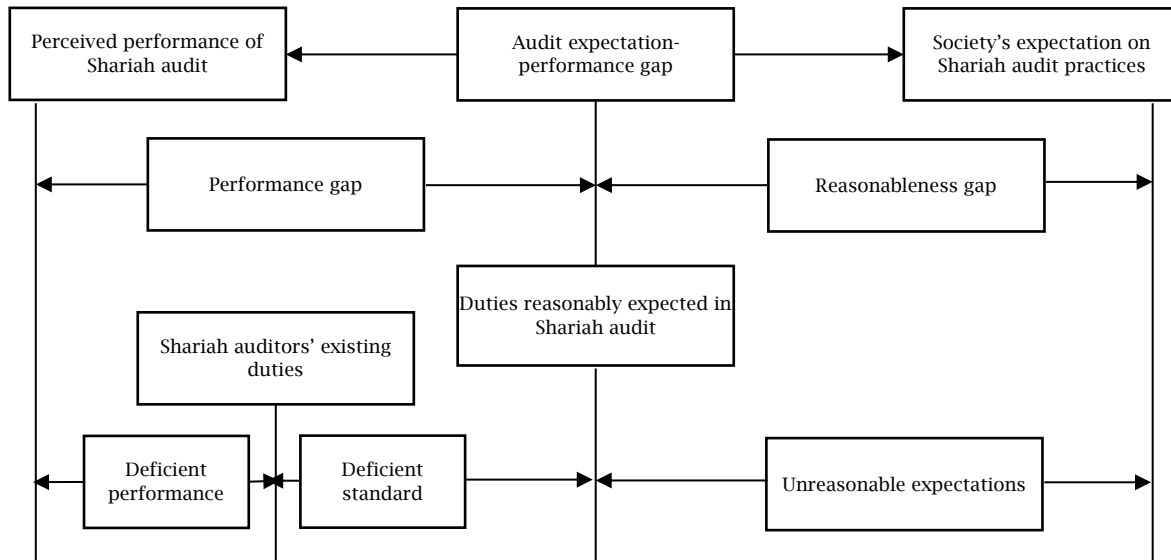
Porter (2010). This theory focuses on the 'expectation-performance gap' in terms of Shariah governance and audit practices in Islamic co-operatives in Malaysia. The evaluation is based on two contributing factors: 1) the performance gap and 2) the reasonableness gap. This expectation-performance gap is embedded in the protocol questions used during the series of focus group discussions conducted for data collection purposes. These questions were approved by a Shariah audit subject matter expert. The discussions were audio-recorded and transcribed. Thematic analysis based on consensus was conducted, and inputs were gathered and analyzed to produce thematic results. Any questions that did not reach consensus were discussed further in a second round of roundtable discussions. Responses were categorized to ensure the confidentiality of respondents' names, positions, and the organizations for which they work. The responses in this study were coded from R1 to R11.

4. RESULTS AND DISCUSSIONS

The objective of this study is to explore the expectation-performance gap in Shariah governance and audit practices in Islamic co-operatives, specifically examining the gap between co-operative members' expectations of

Shariah governance and audit and its performance as perceived by practitioners (i.e., SKM, Shariah officers, Shariah/internal auditors, and external auditors). After two series of roundtable discussions, the findings of this study are summarized in Figure 2 below.

Figure 2. Framework of audit expectation-performance gap in Shariah governance and audit practices



Source: Authors' elaboration.

There are two major components involved in this study: 1) the reasonableness gap and 2) the performance gap. The reasonableness gap refers to the difference between co-operative members' expectations regarding Shariah governance and audit practices and what can reasonably be expected from these practices. Meanwhile, the performance gap is the difference between what co-operative members can reasonably expect Shariah audit practices to achieve and what they perceive these practices are actually achieving. The performance gap can be further divided into:

a) *Deficient standards* — the gap between the duties reasonably expected of the Shariah committee and internal auditors, as defined by *GP28: Garis Panduan Tadbir Urus Syariah* (SKM, 2015), and their existing duties.

b) *Deficient performance* — the gap between the expected performance standards of internal auditors' duties related to Shariah compliance and their perceived performance, as expected and perceived by co-operative members.

In summary, the research findings indicate that there is an expectation-performance gap in Shariah governance and audit in Islamic co-operatives, particularly concerning regulation, framework and guidelines, independence and competency, and Shariah audit scope in governing Shariah compliance principles. The gap is explained in detail as follows.

4.1. Expectation-performance gap in regulation

The co-operative sector faces significant issues and challenges, as there is currently no specific act governing Islamic co-operatives. The absence of a dedicated act or regulation for Islamic

co-operatives may lead to problems if existing regulations are not in compliance with Shariah principles or if they hinder the process of Shariah compliance (Itam et al., 2016). This raises the question of whether current co-operative mechanisms can ensure adherence to Islamic Shariah principles and the *maqasid*. For instance, the use of the *ar-rahnu* contract versus *tawarruq* as the underlying contract for micro-financing offered by *ar-rahnu* operators and co-operatives has led to inconsistencies in practices.

The roundtable discussion was guided by several questions to achieve the research objectives. During the first round, respondents briefly explained the governance practices within each institution. There are diverse practices across the co-operative sector, with some having internal Shariah committees while others outsource this function depending on the size of the co-operative. Respondent R1 mentioned:

"On Shariah compliance, we are still in the developing stage, as we are evaluating the best policies and processes for compliance. In terms of product development, our institution has hired Shariah advisors to provide guidance on Shariah matters, even though it is not a requirement under SKM. We do this on a voluntary basis. It is quite costly for the institution, but it may be something that needs to be addressed" (Respondent R1, May 24, 2021, personal communication).

An external auditor noted that it is essential for each Islamic co-operative to have its own Shariah committee, similar to practices in Islamic financial institutions, as this would govern the institution's overall operations to ensure Shariah compliance. He added that if Shariah advisory services are only present at the regulatory level, some important

Shariah-related matters might be overlooked or misinterpreted. Additionally, the external auditor suggested that while Shariah advisory services at the regulatory level are efficient for general monitoring, they may not be as effective in detailed Shariah compliance monitoring. Thus, this study concluded that the presence of a Shariah committee at each co-operative level is crucial for ensuring the effective application of Shariah principles in operations.

In addition to the roundtable discussions, a quick random survey was conducted among co-operative members regarding their awareness of the Shariah department/Shariah committee at the regulatory level in SKM. The survey revealed that 73.4 percent were aware of the Shariah department/Shariah committee at the SKM level. However, 15.6 percent did not know of its existence, and 10.9 percent were unsure of its functions. This indicates a gap between the expectations of co-operative members and actual practices.

4.2. Expectation-performance gap in framework and guidelines

In the context of increasing public awareness and sensitivity to Shariah compliance in financial and business practices, the presence of Shariah audit functions is becoming increasingly relevant. This scenario introduces a new dimension to risk management, which should now include Shariah non-compliance risk management. According to the roundtable discussions, the majority of respondents agree that conducting Shariah audits in Islamic co-operatives is essential to minimize Shariah non-compliance risk.

Shariah non-compliance risk refers to the potential loss resulting from failure to adhere to Shariah rules and principles set by regulators, which can negatively impact the institution's reputation. Co-operatives can build trust with stakeholders and enhance their institutional reputation by effectively managing Shariah non-compliance risks. This aligns with a previous study by Shah et al. (2018), which noted that Shariah non-compliance risks can affect public confidence in *ar-rahnu* service providers and expose institutions to reputational damage. Specifically, Respondent R2 agreed that Islamic co-operatives need to conduct Shariah audits as part of mitigating Shariah non-compliance risks, stating:

"As you offer Shariah-compliant products, you need to have Shariah audit functions in your institution to ensure proper checks and balances. During my fieldwork, one of the audit findings was that the co-operative staff had confused some Shariah principles, such as the application of ta'widh and gharamah. The co-operative recognized gharamah as income for the institution, whereas it should be channeled to charity" (Respondent R2, May 24, 2021, personal communication).

Respondent R2 also emphasized the importance of establishing a proper Shariah audit framework. An established Shariah audit function is crucial for ensuring adherence to Shariah principles. Other respondents commented on the importance of Shariah audits in co-operatives, noting that they complement the annual reports on Shariah compliance. These reports are valuable to shareholders and other stakeholders, as they allow for the evaluation of co-operative institutions based

on their financial performance in accordance with Shariah principles.

During the discussions, respondents believed that Shariah audits could help detect Shariah non-compliance risks at an early stage. For example, if a Shariah violation occurs, the Shariah auditor can advise on ways to address it. Management also plays a crucial role in ensuring that staff follow the Shariah auditor's recommendations for rectification and improvement. Respondent R4, however, viewed the situation from a different perspective, stating:

"I initiated a Shariah audit for this co-operative, but one of the staff questioned how we know about Shariah audits. From our conversation, I can conclude that they are still unaware of Shariah audits" (Respondent R4, December 6, 2022, personal communication).

According to SKM (2015) in GP28, Shariah principles are the foundation of Islamic business, with compliance with the pillars, requirements, and principles established by *syarak* being the most critical aspect. Shariah compliance increases public trust in the Islamic financial system, particularly in the co-operative sector, which is why Shariah audits are essential. Respondent R2 added:

"Co-operatives can refer to SKM's guidelines GP28: Garis Panduan Tadbir Urus Syariah, which highlight the importance of Shariah governance. Since Shariah audit is part of Shariah governance, the closest comparison is the Shariah governance guidelines by SKM. I hope that in the future, SKM will issue standard guidelines for Shariah audits, as they are currently mandatory only for Islamic financial institutions and takaful operators, but not for co-operatives" (Respondent R2, December 6, 2022, personal communication).

Shariah audits should be made mandatory in co-operative institutions in the future, as many co-operatives already engage in Shariah-based activities and need to ensure effective Shariah governance. The study concludes from the third round of discussions on auditing co-operatives that it is essential to ensure co-operatives conduct Shariah audits in accordance with Shariah compliance requirements. Respondent R2 mentioned:

"We must act quickly to convince the regulator that Islamic financial institutions have completed Shariah audits and that co-operatives should do the same. It is the regulator's responsibility to swiftly develop regulations for all co-operative sectors. We want to reassure the public that the products offered by co-operatives are Shariah-compliant" (Respondent R2, May 24, 2021, personal communication).

It is commendable that some co-operatives are voluntarily conducting Shariah audits, as this indicates that monitoring of Shariah principles is being carried out appropriately. The lack of a standardized framework and guidelines in Shariah governance and audit practices can lead to inconsistencies and challenges in ensuring compliance with Islamic principles in financial and business transactions. Establishing clear and comprehensive guidelines is crucial to maintaining transparency, ethical conduct, and stakeholder trust in Islamic co-operatives (Kamaruddin, Shafii, et al., 2024).

To address these issues, Islamic co-operatives, scholars, and regulatory bodies are working to

develop and promote best practices in Shariah governance and audit. These efforts aim to provide a structured framework for Islamic co-operatives to follow, ensuring their operations adhere to Shariah principles and ethical standards. It is important for practitioners and institutions involved in Islamic finance, including Islamic co-operatives, to stay updated on these evolving guidelines and adhere to them to enhance the credibility and reliability of their Shariah compliance practices.

4.3. Expectation-performance gap in independence and competency of Shariah auditor

Respondent R2 added during the second round of discussions on the role that auditors play in the establishment of Shariah governance by stating:

“The auditor must ensure the board audit committee is well-versed and aware of Shariah principles, because the internal Shariah auditor will seek reference and advice from the audit committee. The Shariah auditors themselves must be competent and independent when performing their duties” (Respondent R2, December 6, 2022, personal communication).

Both the auditor and the board audit committee must be competent and well-versed in conducting Shariah audits in Islamic co-operatives. Islamic co-operatives that do not have a dedicated Shariah expert, should consider recruiting or outsourcing a Shariah advisor to handle Shariah audits. This approach is also valid for the implementation of Shariah audits, as Islamic co-operatives must have their own audit procedures to ensure compliance with Shariah principles (Kamaruddin, Salleh, et al., 2024).

These results are consistent with other studies that highlight the importance of independence and competency for Shariah auditors in Islamic co-operatives. An auditor needs strong expertise in both accounting and Shariah principles to effectively conduct a Shariah audit (Mohamad Puad et al., 2020). Although competency is a primary concern, Shariah auditors should be capable of making decisions to ensure productivity. A study found that even existing auditors sometimes lack the necessary knowledge to enforce certain aspects of Shariah compliance. Due to limited resources available for fully implementing Shariah principles, Shariah governance can be challenging to execute (Surkery & Yaacob, 2019). Additionally, the auditor's expertise is currently limited to auditing safety, finance, and auctions, without encompassing the aspect of Shariah compliance (Refo et al., 2021).

The findings further support the need for auditors to gain additional exposure through Shariah-certified training programs offered by reputable organizations like Islamic Banking and Finance Institute Malaysia (IBFIM), as well as through continuing professional development from organizations like the Malaysian Institute of Accountants (MIA), in addition to internal training provided by experienced Shariah auditors (Kamaruddin et al., 2023). Furthermore, auditors should be independent, unbiased, and free from personal biases that could interfere with or damage the operations of Islamic co-operatives. They should also be knowledgeable, provide responsible

responses, and maintain the confidentiality of their findings.

The independence and competency of a Shariah auditor are crucial factors in ensuring the integrity of Islamic co-operatives and their compliance with Shariah principles. Based on the discussions, independence refers to the auditor's ability to exercise objective and impartial judgment in assessing compliance with Shariah principles. Shariah auditors should be free from any conflicts of interest that could compromise their objectivity. Competency relates to the auditor's knowledge, skills, and expertise in Shariah principles and financial matters. It is expected that Shariah auditors must have a deep understanding of Islamic finance principles, jurisprudence (*fiqh*), and relevant legal frameworks. They should stay updated with changes in Shariah standards and financial regulations. Additionally, professional certifications and ongoing education can demonstrate their competency (Kamaruddin & Hanefah, 2017).

In summary, an independent Shariah auditor should be free from conflicts of interest, while a competent auditor should possess the necessary expertise in Islamic finance and Shariah principles. These qualities help maintain trust in Islamic co-operatives and ensure they adhere to ethical and religious standards.

4.4. Expectation-performance gap in Shariah audit scope

The fourth round of discussions focuses on the scope of Shariah audits. The respondents agree that a Shariah auditor should evaluate Shariah aspects thoroughly. In general, the Shariah auditor will examine the internal controls of Islamic co-operatives' operations, which includes reviewing documentation, operational processes, compliance with regulations and laws, and Shariah-related areas. According to Respondent R2:

“An auditor will look at an institution's internal control, and the first thing that a Shariah audit will focus on is whether the institution's internal control is effective or not” (Respondent R2, May 24, 2023, personal communication).

“The purpose of an audit is to examine the processes and procedures, akad contracts, standard operating procedures, calculations, and documentation in the Shariah area, as well as the effectiveness of internal controls” (Respondent R2, May 24, 2023, personal communication).

Representatives from the co-operative sector agree that the Shariah audit scope should include inspecting both the internal control areas and the Shariah aspects of business operations. All Shariah areas must be audited to ensure that institutions conduct their operations in compliance with Shariah principles. This result is consistent with previous discussions, where Shariah auditors must examine internal control mechanisms to prevent any Shariah violations (Yaso et al., 2023). The audit scope mentioned by Respondent R2 could be expanded to include additional areas, such as the security of products, contracts and agreements, transactions, policies, financial statements, as well as memorandums and articles (Khalid et al., 2021).

The scope of a Shariah audit typically involves a comprehensive review of a co-operative's financial transactions, investments, and business operations to ensure they comply with Islamic principles. This includes examining all financial transactions, such as financing, investments, and contracts, to ensure they are structured in accordance with Islamic finance principles, which prohibit interest (*riba*) and excessive uncertainty (*gharar*) (Kamaruddin, Shafii, et al., 2024).

It is important to note that the specific scope of a Shariah audit can vary depending on the nature of the organization, its activities, and its adherence to Islamic principles. Shariah audits are often conducted by qualified Islamic scholars or Shariah auditors who have expertise in Islamic finance and jurisprudence.

5. CONCLUSION

In conclusion, based on the findings, there is an expectation-performance gap in the regulation, framework, guidelines, independence and competency, and Shariah audit scope for governing Shariah compliance principles in Islamic co-operatives. This gap is crucial because a well-defined regulation, framework, and guidelines in Shariah governance and audit will increase stakeholders' trust that the activities and operations of Islamic co-operatives are Shariah-compliant.

Additionally, the development of standardized frameworks will help manage the risks associated with Islamic co-operatives and contribute to the growth of the industry and the economy by providing adequate disclosure for stakeholders to make informed decisions. Islamic co-operatives must conduct Shariah audits to ensure Shariah compliance. Most co-operatives have already established internal audits and are working towards setting up a comprehensive governance structure in the future.

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The research indicates that there is currently no specific guideline on Shariah audits for co-operatives to refer to. Therefore, regulators like SKM and the Co-Operative Institute of Malaysia (*Institut Koperasi Malaysia*, IKMa) need to develop a specific Shariah framework and guidelines to address the issues raised in this study. Additionally, Shariah compliance training programs should be provided to equip Shariah officers in Islamic co-operatives with the necessary skills to implement Shariah compliance practices. This can be achieved through collaboration with higher education institutions that have expertise in this field. Finally, SKM, as the regulator, needs to play an active role in overseeing and enforcing Shariah governance to ensure Shariah compliance practices in Islamic co-operatives in Malaysia.

Among the limitations of this study is the lack of awareness and initiative among Islamic co-operatives. Some co-operative members are unaware that Shariah audits are required, despite their business activities being Shariah-based. Therefore, the findings of this study could inform the development of Shariah audit guidelines for Islamic co-operatives. The co-operative sector should start implementing Shariah audits before regulations are enforced, as it is a proactive initiative to assess the efficiency of the Shariah governance process.

For future research, there is a need to continue the study by identifying the suitable mechanism for Shariah audits especially in Islamic co-operatives including Shariah audit scopes, tools, programs and executions. Moreover, a study on the existing related guideline such as *GP28: Garis Panduan Tadbir Urus Syariah* need to be done and necessary amendment need to be suggested by incorporating the latest practice in Shariah audit. Lastly, the study on Shariah audit practice in Islamic co-operatives should be expended to other co-operative type rather than micro-credit and ar-rahnu at the moment.

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