

**THE SCOPE OF *SHARIAH* AUDIT IN ISLAMIC FINANCIAL INSTITUTIONS (IFIs):
A COMPARATIVE STUDY OF MALAYSIA AND INDONESIA.**



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SEPTEMBER 2012

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Rujukan Kami : 100-FPN/ARI (PT.16/5/6d-1/29/2010)
Tarikh : 28 Mei 2010

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KELULUSAN PERMOHONAN DANA ARI HICoE 1/2010

Tajuk Projek : The Scope of Shariah Audit in Islamic Financial Institutions (IFIS): A comparative Study of Malaysia and Indonesia.
Kod Projek : 100-FPN/ARI (PT.16/5/6d-1/29/2010)
Kategori Projek : Sains Sosial dan Kemanusiaan
Tempoh : 18 Bulan (Julai 2010 Jan 2012)
Jumlah Peruntukan : RM 39,500

Dengan hormatnya perkara di atas adalah dirujuk.

2. Sukacita dimaklumkan pihak Universiti telah meluluskan cadangan penyelidikan Prof/Prof. Madya/Dr./Tuan/Puan dan bersetuju untuk membiayai projek penyelidikan tersebut di bawah Dana ARI HICoE.

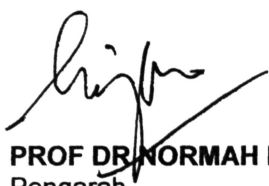
3. Pihak Universiti mengucapkan tahniah kepada di atas kejayaan ini dan di harap dapat menyiapkan projek ini dengan cemerlang.

4. Untuk tujuan mengemaskini, pihak Prof/Prof Madya/Dr./Tuan/Puan adalah diminta untuk menyusun perancangan semula bajet yang baru seperti yang diluluskan. Sila lihat lampiran A bagi tatacara pengurusan projek serta taqvim untuk pembentangan kemajuan projek secara berkala.

Sekian, terima kasih.

“SELAMAT MENJALANKAN PENYELIDIKAN DENGAN JAYANYA”

Yang benar



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4. Report

4.1 Executive Summary

Drastic development of Islamic financial institutions globally may lead to new expectations of and requirements for accountability, which in turn lead to new demands on the audit function of the institutions. The prohibition of interest and the aspiration of Muslims to make this prohibition a practical reality in their economies, has led to the establishment of a number of Islamic financial institutions around the world. Religious or *Shariah* audit evolved in parallel to the development of these institutions. The study examines the scope of the current practice of auditing in Islamic financial institutions using questionnaires survey in Indonesia and Malaysia. It further examines if IFIs manage to strengthen their social accountability dimension towards their social objectives via their auditing function.

This is imperative as the IFIs are expected not only to avoid transactions on the basis of interest but also to participate actively in achieving the goals and objectives of an Islamic economy. The research reports findings on the need to extend the scope of *Shariah* audit to a broader sense to be in line with the socio-economic objectives of the Islamic law. It is also found that IFIs are facing with serious challenges from the well-established conventional financial system whereby *Shariah* auditors may face with immense challenges from the policy makers and top management who are progressive thinkers of diverse faiths and practices. Above all, lacking in a comprehensive *Shariah* audit framework and expertise add to the problem of implementation of *Shariah* audit in IFIs. Finally, it offers recommendations to bridge the gap between the theory and practice.

4.2 Introduction

Recent accounting scandals, where companies prepared fraudulent financial statements, and auditors issued clean opinions on the fraudulent statements, have eroded the trust among participants in the financial markets. During the late 1990s, Sunbeam corporation went into bankruptcy and in early 2002, Enron and Worldcom, two large corporations in the world collapsed losing billions of dollars. People have started to re-evaluate the level of trust they put on audit to provide assurance for investment and financial information, and the trend of solely depending on audit as the best source of credibility for such information may have now become defunct (Humphrey, 2000).

Despite all these tragedies, the conventional auditing system arising from a Western capitalistic philosophy and values is the only procedure and system available being adopted globally. Unfortunately, Islamic financial institutions (IFIs) which are set up with different objectives and worldview, and is drastically growing in numbers worldwide, have not much choice but to depend on the conventional system for audit purposes. In view of their early stage, Islamic banks for instance, have no mandatory regulated guides on auditing practices and accounting standards (Banaga et al., 1994). AAOIFI, a standard setting body for IFIs, responsible for setting up accounting and auditing standards, has also come under criticisms by certain quarters on its methodology. Shahul (2000) for instance called for an extensive overhaul for Islamic accounting if it were to endure for a long time. Indonesia, a neighbour country to Malaysia, with Muslim majority population, has also taken an initiative in producing a *Shariah Audit Manual* for its IFIs.