AUDIT QUALITY INDICATORS IN ISLAMIC BANKS: A COMPARATIVE STUDY AMONG SELECTED MUSLIM MAJORITY COUNTRIES

BY

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ABSTRACT

Corporate scandals, fraud and the credibility of firms' financial statements depend on the level of audit quality provided by the audit firm. The financial statements are a tool in discharging management's responsibility towards the principal. However, there exists a possible conflict of interest between management and shareholders. Therefore, the auditing process is needed to verify that the financial statements are in conformity with accounting standards and also reflect the economic reality of company's transactions and financial performance. Auditors are responsible for the quality of individual audits, and should aim to ensure that quality audits are consistently performed. Therefore, it is important that the highest possible level of audit quality is maintained, especially in Islamic banks. However, it is difficult to measure audit quality. Therefore, many studies measure audit quality using proxies or indicators. This study used audit quality indicators (AQI) which are available in audited financial statements of Islamic banks. Moreover, Islamic banks up hold the principle of Islamic accountability to all activities. These banks have to be accountable to more stakeholders, and ultimately to God. Thus, Islamic banks must be more transparent about their activities and performance. This study expects that the level of audit quality in Islamic banks to improve each year. Therefore, the objectives of this study are to determine the availability of audit quality indicators of Islamic banks, to investigate the differences of audit quality in Islamic banks and to investigate the improvement of audit quality in Islamic banks from 2007 to 2011 in Indonesia, Malaysia, Pakistan, Bahrain, Qatar, Saudi Arabia, and United Arab Emirates (UAE). In addition, this study used agency theory and the concept of Islamic accountability as the theoretical framework. This research used annual reports and the population of 23 full-fledged Islamic commercial banks from 2007 to 2011 in Indonesia, Malaysia, Pakistan, Bahrain, Qatar, Saudi Arabia, and United Arab Emirates (UAE) in order to meet the research objectives. The findings of this research indicate that there is a slight statistically significant difference in AQI of Islamic banks in the different countries. However, in general, there is no statistically significant improvement in the overall AQIs between 2007 and 2011. Even though the overall results indicate no improvement, Islamic banks in different countries had improved in terms of their specific AQIs over the 5 year period.

خلاصة البحث

هناك علاقة مباشرة بين فضائح الشركات والاحتيال وسلامة البيانات المالية من ناحية وبين مستوى جودة تدقيق الحسابات التي تقدمها شركة مراجعة الحسابات. إنَّ البيانات المالية عبارة عن الأداة التي تستخدمها الإدارة المسؤولة أمام المساهمين وأصحاب رأس المال. ومع ذلك، فإنَّ هناك احتمالاًلوجود تضارب محتمل في المصالح بين الإدارة والمساهمين؛لذايتعين على عملية التدقيق أن تتحقق من أنَّ البيانات المالية متوافقة مع المعايير المحاسبية،وتعكس أيضاًالواقع الاقتصادي لهذه الصفقة والأداء المالي للشركة. إنَّ المدقق هو المسؤول عن تدقيق الجودة للفرد، ويهدف إلى ضمان أن يتم تنفيذ جودة التدقيق باستمرار. ولذلك فإنَّ من الأهمية بمكان المحافظة على أعلى مستوى من جودة التدقيق في المصارف الإسلامية. إننا ما زلنا نفتقر إلى البحوث المتعلقة بمؤشرات جودة تدقيق الحسابات(**AQI**) في البنوك الإسلامية.كما أنَّ كمية العمل الرقابي ونوعيتهليست قابلة للقياس المباشر. ولذلك فإنَّ الكثير من الأبحاث تقتصر على محاولة قياس مراجعة الجودة باستخدام العينات. وتستخدم هذه الدراسة معلومات مستقاة من مؤشرات جودة تدقيق الحسابات (**AQI**) الواردة في البيانات المالية المدققة في المصارف الإسلامية. بالإضافة إلى ذلك، فإنَّ المصارف الإسلامية تعتمد في تنفيذ جميع أنشطتها على المبادئ الإسلامية، ويجب أن تكون مسؤولة أمام الله أولا ثمَّ أمام الجهات المعنية بعد ذلك، ويجب أن تكون المصارف الإسلامية أكثر شفافية فيما يتعلق بأنشطتها وأدائها. وتتوقع هذه الدراسة أن يرتقي مستوى جودة التدقيق في المصارف الإسلامية إلى مكانة أعلى مع زيادة مستويات مراجعة الجودة كل عام. ولذلك فإنَّ الغرض من هذه الدراسة يتمثل في تحديد مدى توافر مؤشرات جودة التدقيق في المصارف الإسلامية، وذلك من أجل تحقيق الاختلافات في نوعية المراجعة لدى المصارف الإسلامية ولتحقيق تحسين جودة التدقيق في تلك المصارف الإسلامية بين عامي 2007 و 2011 في إندونيسيا، وماليزيا، وباكستان، والبحرين، وقطر، والمملكة العربية السعودية، والإمارات العربية المتحدة. وبالإضافة إلى ذلك فإنَّ هذه الدراسة تعتمد على نظرية الإسلام ومفاهيمهباعتبارها الإطار النظري لدعم هذا البحث. وتستخدم هذه الدراسة البيانات المالية السنوية لثلاثة وعشرين بنكاً إسلامياً، خلال الفترة من 2007-2011 في المصارف الإسلامية في إندونيسيا، وماليزيا، وباكستان، والبحرين، وقطر، والمملكة العربية السعودية، والإمارات العربية المتحدة؛ من أجل تحقيق أهدافها. وأظهرت نتائج هذه الدراسة أنَّ هناك فروقاً ذات دلالة إحصائية في المصارف الإسلاميةالصغيرة بين مختلف هذه البلدان. لكن بشكل عام لم يكن هناك تحسن ملحوظ إحصائياً فيمؤشرات جودة تدقيق الحسابات **AQIS** الشاملة بين عامي 2007 و 2011،وعلى الرغم من أنَّ النتائج الكلية لم تظهر أي تحسنفإنَّ هذه المصارف الإسلاميةفي مختلف البلدان قد اعتمدت بشكل كبير علىمؤشرات جودة تدقيق الحسابات**AQIS**خصوصاً خلال فترة تلك السنوات الخمس.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Accounting).

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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LIST OF ABBREVIATIONS

AAOIFI	: Accounting and Auditing Organization of Islamic Financial Institutions
AQI	: Audit Quality Indicators
NAS	: Non-Audit Services
SSB	: Shariah Supervisory Board
FinSSB	: Financial literacy of SSB
ShaSSB	: Shari’ah background of SSB
FinShaSSB	: Both financial and Shari’ah background of SSB
TAQIDM	: Total Audit Quality Indicator Dimension
IAASB	: International Auditing and Assurance Standards Board
PLS	: Profit-Loss Sharing

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Management is responsible to report the financial position of the firm to stakeholders and financial statements are considered to be the main instrument of conveying relevant financial information. Thus, financial statements are a tool in discharging management's responsibility towards the principal. However, there exists a possible conflict of interest between management and shareholders. Therefore, the auditing process is needed to verify that the financial statements are in conformity with accounting standards and reflect the economic reality of company's transactions and financial performance (Al-Thuneibat, Al Issaand and Baker, 2011).

Audit quality is an essential element for the continued existence and survival of the auditing profession (Herrbach, 2001). The significance of the auditing profession became more obvious to the public after The Sarbanes-Oxley Act (SOX), 2002 that noted the increasing concerns of investors about the integrity of firms' financial reporting. This is due to scandals involving big companies, such as Enron and WorldCom as well as one of the Big 5 audit firms, Arthur Andersen (Ziaee, 2014). Therefore, according to the IAASB (2013) auditors must ensure audit quality. "Auditors are responsible for the quality of individual audits, and should aim to ensure that quality audits are consistently performed. A quality audit is likely to be achieved when the auditor's opinion on the financial statements can be relied upon as it was based on sufficient appropriate audit evidence obtained by an engagement team that exhibited appropriate values, ethics and attitudes; was sufficiently knowledgeable and experienced and had sufficient time allocated to perform the audit work; applied a rigorous audit process and quality control procedures; provided valuable and timely reports; and interacted appropriately with a variety of different stakeholders" (International Auditing and Assurance Standards Board (IAASB), 2013).

Therefore, improving audit quality is of specific concern to regulatory bodies as well as the accounting profession (Hakim and Omri, 2009). However, Dao, Raghunanda, and Rama (2012) argue that the quantity and quality of audit work is not directly measurable. Therefore, many studies in audit quality try to measure the audit quality using a proxy or indicators. For instance, the proxies of audit quality are audit firms size, client firm size, audit fee, audit time, audit tenure, auditor specialization, and corporate governance (DeAngelo, 1981a and 1981b; Carcello, Hermanson, and McGrath, 1992; Schauer, 1999; Arruñada, 2000; Bamber, and Bamber, 2009; Boone, Khurana, and Raman, 2010; Chambers and Payne, 2011; Daugherty, Dickins, Hatfield, and Higgs, 2012). Similarly, Audit Quality Indicators (AQIs) are used in this study.

Although many studies have been conducted in the field of Islamic banks, these studies tend to focus more on banks' operations and governance (Satkunasingam and Shanmugam, 2004; Dusuki and Abdullah, 2007). These were also audit studies conducted on internal audit issues and conventional banks (Lau, 1999; Chu, Mathieu, and Mbagwu, 1999; Siddique, and Podder, 2002; Ojo, 2007; Kanagaretnam, Krishnan, and Lobo, 2010; Al-Matarneh, 2011). However, studies that investigate audit quality of Islamic banks, through indicators, are still lacking. Hence, there is gap in the literature that has to be filled. The importance of an audit quality study on Islamic banks is highlighted further in the discussion of the problem statement below.

1.2 PROBLEM STATEMENT

The global financial crisis in 2007 is one of the worst financial crisis since the Great Depression of the 1930's. It led to the loss of banking industry of the United States (US) that also contributed to the failure of key businesses in other countries. It the on-going debate on this issue has centred around the question of the role of accountants in the financial crisis. Specially, it asked whether auditors providing lack of transparency in companies' financial reporting or weak financial audits that led to the financial issues. Therefore, audit quality is very important in business practices.

As a business entity, Islamic banks have a similar goal to conventional banks, which is to generate profit. The exception is Islamic banks operate in accordance with the rules of the Shari'ah, known as Fiqh al-Muamalat (Islamic rules on transactions). Islamic banking prohibits interest charges (riba) on all its transactions and activities. Therefore, Islamic banking provides Islamic contracts to replace transactions with riba. These transactions are based on real assets and profit-loss sharing (PLS). The contract of PLS is an agreement between two or more transacting parties that agree to use their resources to be invested in a project to share based on profit and loss in which reward-sharing is related to risk-sharing between transacting parties (Ahmad, 1993).

Additionally, Islamic banks not only have managers and shareholders, but they have depositors. Therefore, similar to the conventional banks, Islamic banks face agency conflict, which may lead to negative reputation of the banks. It is even more important for these banks to maintain their credibility and reputation. This is because the reputation of these banks is connected with the religion itself since they are established on the basis of the Shari'ah. Hence, it is vital that agency cost and potential conflict are properly monitored by auditors of Islamic banks. High quality financial reporting can reduce the impact of agency conflict and the quality of Islamic bank's financial reporting can be maintained with high audit quality.

Consequently, research on audit quality in Islamic banks is essential. However, most of the studies on audit quality concentrate on listed companies and firms in developed countries. Additionally, there are some studies related to audit in banks but these studies are more on internal audit issues and in conventional banks (Lau, 1999; Chu, Mathieu, and Mbagwu, 1999; Siddique, and Podder, 2002; Ojo, 2007; Kanagaretnam, Krishnan, and Lobo, 2010; Al-Matarneh, 2011). However, similar to other companies and banks, audit quality is also difficult to measure in Islamic banks. Generally, proxies or indicators are used to measure audit quality by prior literatures (Wahab and Zain, 2013; Barua and Smith, 2013; Eddine, 2012; Aljaaidi and Bukair, 2012; Vinnicombe, 2012; Barua and Smith, 2013; Sun and Liu, 2010; Francis and Yu, 2009). These studies also used very few indicators to measure audit quality. The studies also do not attempt to compare Audit Quality Indicators (AQI) of Islamic banks in various Muslim countries. This allows for an extension of the study, as specified by the objectives of the study below.

1.3 OBJECTIVES OF THE STUDY

This study analyses annual reports of Islamic banks from selected Muslim countries. The selected countries are Indonesia, Malaysia, Pakistan, Bahrain, Qatar, Saudi Arabia and United Arab Emirates (UAE). The objectives of the study are as follows:

1. To determine the availability of audit quality indicators (AQI) of Islamic banks in Indonesia, Malaysia, Pakistan, Bahrain, Qatar, Saudi Arabia, and United Arab Emirates (UAE).

2. To investigate whether there is a difference in availability of AQI of Islamic banks in the selected Muslim majority countries.
3. To investigate whether there is an improvement in availability of AQI in Islamic banks in the selected countries from 2007 to 2011.

Based on these research objectives, this study hopes to answer the following questions:

1. To what extent are AQI available in annual reports of Islamic banks in Indonesia, Malaysia, Pakistan, Bahrain, Qatar, Saudi Arabia, and United Arab Emirates (UAE)?
2. Is there a difference in availability of AQI of Islamic banks in the selected countries?
3. Is there an improvement in availability of AQI of Islamic banks in the selected countries from 2007 to 2011?

Previous studies measured the audit quality by using proxies such as audit fee, audit tenure and related audit quality indicators. Hence, this study uses audit quality indicators (AQI) based on available information in audited financial statements of Islamic banks from 2007 to 2011 to achieve the research objectives.

1.4 MOTIVATIONS OF THE STUDY

Audit quality in Islamic banks is crucial. The quality of Islamic bank's financial reporting can be maintained through high audit quality. This study on audit quality in Islamic banks is motivated by several reasons:

Firstly, it is important to know the audit quality of Islamic banks in Muslim majority countries such as Indonesia, Malaysia, Pakistan, Bahrain, Qatar, Saudi Arabia, and United Arab Emirates (UAE). Although, there are many audit quality studies in the developed countries, the environment such as economy, business, culture, regulation and the level of enforcement are likely to be different in developing countries. It may lead to different levels of audit quality in each country (Aljaaidi and Bukair, 2012).

Secondly, this study is motivated in order to know the indicator of audit quality in Islamic banks in Muslim majority countries. The Audit Quality Indicators (AQI) would indicate which countries have higher audit quality. One way to find AQI is from audited financial statements of Islamic banks. Financial statements summarize important information about Islamic banks such as audit firms that audited Islamic banks' financial statements and corporate governance indicators such as audit committee and independent Board of Directors (BOD). The financial figures in financial statements also provide a measure of AQI, such as audit fees.

Thirdly, this study is also motivated to assist the stakeholders, shareholders, and Ummah to gain an insight on the audit quality of Islamic banks. Stakeholders and investors expect high audit quality from Islamic banks. This is because Islamic banks should bring religious values in all its activities and transactions and at the same time, they have to comply with Shari'ah. In fact, high audit quality leads to high reputation and trust in Islamic banks.

Fourthly, the motivation for the study is also to find out the relationship between audit quality and transparency of Islamic banks. Khan (1998) states that the main objective of Islamic banks is to provide transparency and promote the value of Islamic society. In fact, Islamic banks have a responsibility that is not only directed towards its shareholders but also to the community as part of Islamic accountability (Satkunasingam and Shanmugam, 2004; Lewis, 2001; Maali, Casson and Napier, 2006). High transparency of Islamic banks leads to fulfilments of responsibilities to stakeholders and the public at large, as well as Islamic accountability. Higher audit quality of Islamic banks may reflect transparency of Islamic banks because information of audit quality indicators (AQI) is available on audited financial statements.

Lastly, this study is motivated by the reason that there is a lack of research in this area, as mentioned before. Some audit studies in banks have been conducted mostly on internal audit issues and conventional banks (Lau, 1999; Chu, Mathieu, and Mbagwu, 1999; Siddique, and Podder, 2002; Ojo, 2007; Kanagaretnam, Krishnan, and Lobo, 2010; Al-Matarneh, 2011). Audit quality indicators may still be lacking in Islamic banks, thus, this research findings may be able to provide Islamic banks with ways to improve their weaker indicators of audit quality.

1.5 SIGNIFICANCE OF THE STUDY

The study hopes to contribute in the following ways:

Firstly, it is to provide a view of current audit quality of Islamic banks in Indonesia, Malaysia, Pakistan, Bahrain, Qatar, Saudi Arabia, and United Arab Emirates (UAE). This study provides an overview of general audit quality of Islamic banks. It will show their audit quality level based on AQI. This is because information of audit quality of Islamic banks is essential for stakeholders, as Islamic banks with higher audit quality may be perceived as being more reliable in terms of investment.

Secondly, it provides findings that can be used by potential shareholders for decision making on business activities that are related to Islamic banks. In addition, the findings provide a comparison of the availability of audit quality indicators in Islamic banks; stakeholders and shareholders may expect to know which banks in Muslim countries have potentially higher quality audit. They may get information of audit quality in Islamic banks' financial reporting. This is because the quality of Islamic bank's financial reporting can be maintained with high audit quality

Lastly, this study contributes by adding to the literature on audit quality, and specifically the literature on Islamic banks.

1.6 ORGANIZATION OF CHAPTERS

The structure of the dissertation is as follows:

Chapter One: Introduction: This chapter presents a brief discussion of the study's background as well as problem statement, objectives of the study, motivation of the study, and significance of the study.

Chapter Two: Literature Review: This chapter provides extensive prior literature review on audit quality indicators. The researcher provides some focus on past studies on audit quality undertaken in the context of emerging economies as the current study is conducted in selected Muslim countries. The researcher also includes a review of audit quality studies in developed countries and developing countries as well. Finally, this chapter highlights some prior studies on auditing in Islamic banks, before identifying the gap in the literature.

Chapter Three: Theory, Hypotheses, and Research Method: This chapter discussed the theoretical foundation of the study. Agency theory is used in this study as many prior studies in audit apply agency theory as a theoretical framework; that client firms tend to hire qualified auditors to reduce the agency costs between principal and agent. In addition, the concept of Islamic accountability is also used in this study since the objective of this study is to attain an indication of the audit quality level of Islamic banks, and accountability should be a vital component in Islamic banks. Moreover, this chapter focuses on the methodology used in this study. The first section highlights the sample selection procedures as well as sample size. Data sources are also explained after which the audit quality indicators are discussed in further detail. Finally, this chapter discusses the data analyses techniques.

Chapters Four: Research Findings: Results of the study are presented in this chapter. Results are presented in tables for ease of understanding. The analyses of the findings are also discussed in this chapter.

Finally, Chapter Five: Conclusion. This chapter concludes the overall study. It provides a brief summary of the results and implication of the findings. Limitations and contribution of the study were also presented, and then suggestions for future research are made before the study is concluded.

1.7 CHAPTER SUMMARY

This chapter provides the background to the study. The problem statement leads on to the objectives of the research as well as the research questions. The motivation and significance of the study are also presented in order to justify the research.

Subsequent to providing the introduction of the study, the next chapter reviews the relevant literature prior to identifying the gap in the literature in this area of research.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

The previous chapter provides the background and introduction to the study. After identifying the research objectives of the study in the last chapter, this chapter proceeds with a review of literature pertaining to the current study. This chapter is organized into five sections. The first section discusses audit quality and reviews literature on proxies of audit quality, specifically those that will become Audit Quality Indicators (AQI) in this study. The next section provides a discussion on audit quality studies, more specifically in developed and developing countries. The subsequent section reviews studies on auditing of Islamic banks. Prior to concluding the chapter, the gap in the literature is identified.

2. 2 AUDIT QUALITY DEFINITION AND ITS INDICATORS

The literature review starts with a brief overview of the definition of audit quality. In this respect, DeAngelo (1981) described audit quality as the ability of the auditor to detect and report the possibility of violation in the client's financial report. Additionally, Elitzur and Falk (1996) described audit quality as the number of standardized units of audit evidence collected by the independent auditors. Moreover, Francis (2011: 127) pointed out "*audit quality is achieved by the issuance of the 'appropriate' audit report on the client's compliance with generally accepted accounting principles".* The essence from all the definitions seems to be that achieving audit quality is related to auditors' capability to identify material error. In this dissertation, audit quality is defined according to the definition issued by IAASB (2013). Based on IAASB (2013), there are three criteria that need to be fulfilled for a quality audit:

1. "A systematic examination and verification of a company's activities must be carried out by independent auditors".
2. These auditors must collect "sufficient appropriate audit evidence to express an opinion on whether the financial statements comply in all material respects" with the financial reporting framework.
3. This assurance by auditors is to enhance the confidence of intended users on the credibility of financial reporting.

According to Balsam, Krishnan, and Yang (2003) as cited in Lin and Hwang, (2010), audit quality is inherently unobservable due to variation in the credibility of auditors that influence the audit quality result. Furthermore, Dao, Raghunanda, and Rama (2012) argued that it is difficult to measure audit quality because quantity and quality of audit work is not directly observable. Hence, many studies on audit quality use a proxy to measure it. These proxies are based on the factors that affect audit quality. There are many factors that may affect audit quality, for instance: auditor size (brand name), provision of non-audit services by audit firms, industry specialization, auditor independence and other proxies. Next, the literature review of this study will highlight audit quality proxies based on previous studies. The proxies of audit quality are used as AQI in more recent studies, as seen later.

2. 2. 1 AUDIT FIRM SIZE

In respect to audit quality and audit firm size, Sun and Liu (2010) studied the relationship between audit quality differentiation between Big National and non-Big National auditors and client-specification litigation risk. They utilized data from the USA for 81,901 listed companies for the period 1988-2006. The study found that Big National auditors provide a higher effectiveness in constraining earnings management as compared to non-Big National auditors. It can be inferred from Sun and Liu's (2010) finding that Big National audit firms, i. e. higher audit firm size, is more effective thus provides higher audit quality than their smaller counterparts.

Fernando, Abdel-Meguid and Elder (2010) examined the effect of certain audit quality attributes, these attributes are auditor size (Big 4), auditor industry specialization and auditor tenure on a client firm's cost of equity capital. They used a sample of 18,955 firms' years of data, of which 18,116 are for Big 4 clients and 839 are for non-Big 4 clients. The study found that auditor size (Big 4), auditor industry specialization and auditor tenure are negatively related with the client firm's cost of equity capital. However, it found that the impact is partial only to small client firms, as a poor information environment is potentially reflected by small client firms. The findings indicate that the market takes more attention on the audit quality attributes, including auditor size, for smaller firms rather than larger ones. The study suggested that the market perceives that the insurance, monitoring and informational roles of auditing are more ‘‘valuable’’ for smaller, less visible firms.

Francis and Yu (2009) conducted a study on audit quality concerning auditor industry expertise and clients' influence on individual practice offices of the Big 4 accounting firms. They used a sample of 6,568 US listed companies in the period from 2003 to 2005 and the total companies which were audited by Big 4 audit firms is