



**AUDIT QUALITY INFLUENCING FACTORS:
COMPARATIVE STUDY BETWEEN ISLAMIC AND
CONVENTIONAL BANKS IN MALAYSIA**

BY

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ABSTRACT

Corporate scandals and fraud have, without any doubt, a direct relation to the level of audit quality provided by the audit firm. Therefore, it is important that the highest possible level of audit quality is maintained, especially in banks as they are fundamental to the strength and stability of a country's economy. Although audit quality in banks is crucial, accounting research tends to focus on disclosure practices or performance measures of these banks. Thus research on audit quality of banks is lacking, particularly in relation to Islamic banks. Research on audit quality may be restricted by the fact that it is difficult to measure, especially for the stakeholders of these banks as they are not part of the audit firm. Nevertheless, there are indicators of audit quality, which are termed as Audit Quality Influencing Factors (AQIF) in this study, and used to obtain an indication of audit quality in Malaysian banks. Also, since Islamic institutions accord all its activities to the principle of Islamic accountability, and have to be accountable to more stakeholders, and ultimately God, this study expects that the level of audit quality in Islamic banks will be higher than conventional ones. Therefore, this study investigates the difference between AQIF of Islamic banks and conventional banks in Malaysia. In addition the study also determines whether there has been an improvement in AQIF in the Malaysian banks in 2009 as compared to 2006. This study analyzes Islamic and conventional banks, 20 banks in 2006 and 33 banks in 2009, listed on Bursa Malaysia. The results of this study found that there is no difference between Islamic and conventional banks' in terms of AQIF. The findings indicate as well that Islamic banks had witnessed significant improvement in their AQIF while conventional banks have not experienced an improvement in most of their AQIF.

خلاصة البحث

فضائح الشركات والاحتيال، دون أي شك، لها علاقة مباشرة بمستوى جودة المراقبة المحاسبية المقدمة من قبل شركة التدقيق. ولذلك، فمن المهم أن يتم الحفاظ على أعلى مستوى ممكن من جودة التدقيق المحسبي، وخصوصا في البنوك، كونها شرطا ساسيا لاستقرار اقتصاد اي بلد. وعلى قدر اهمية المراقبة المحاسبية في البنوك، الا ان البحوث السابقة تميل إلى التركيز على ممارسات الإفصاح أو أداء البنوك. وبالتالي فان الدراسات في مجال نوعية مراجعة الحسابات بالبنوك محدودة، ولا سيما في ما يتعلق بالبنوك الإسلامية. كما ان عددالدراسات في جودة الرقابة المحاسبية يعتبر محدودا لصعوبة قياس درجة نوعية التدقيق المحسبي. ومع ذلك، هناك مؤشرات لقياس نوعية التدقيق المحسبي، التي توصف في هذه الدراسة بالعوامل المؤثرة في جودة التدقيق المحسبي **AQIF**، وتستخدم للحصول على مستوى نوعية التدقيق المحسبي في البنوك الماليزية. باعتبار أن المؤسسات المالية الإسلامية تخضع جميع أنشطتها لمبدأ المسؤولية الإسلامية، فان هذه الدراسة تتوقع أن مستوى جودة التدقيق المحسبي في البنوك الإسلامية ستكون أعلى من التقليدية. ولذلك، فإن هذه الدراسة قامت بالتحقيق في الفرق بين العوامل المؤثرة في جودة التدقيق المحسبي في المصارف الإسلامية والتقليدية بماليزيا. هذه الدراسة قامت بتحليل عينة من 53 مصرفا إسلاميا وتقليديا، في عامي 2006 و 2009، مدرجة في البورصة الماليزيا. نتائج هذه الدراسة توضح أنه لا يوجد فرق بين البنوك الإسلامية والتقليدية من حيث العوامل المؤثرة في جودة التدقيق المحسبي. وتشير النتائج كذلك أن البنوك الإسلامية قد شهدت تحسنا كبيرا في جودة التدقيق المحسبي، بينما البنوك التقليدية لم تشهد تحسنا في معظم العوامل المؤثرة في جودة التدقيق المحسبي.

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.

Chaabane Oussama Housseem Eddine

Signature

Date

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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BETWEEN ISLAMIC AND CONVENTIONAL BANKS IN MALAYSIA**

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In the name of Allah most gracious and most merciful. Praise be to Allah (S.W.T) and peace and prayer be upon the prophet Mohamed (S.A.W), his family, his companions, and his followers until the day of judgement.

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LIST OF ABBREVIATIONS

AQI Audit Quality Influencing Factors
AQ Audit Quality

CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

The auditing profession, as any other profession is a very sensitive occupation in the sense that auditors' services can affect varied groups of stakeholders. The significance of the auditing profession became more obvious to the public after the scandals of Enron and WorldCom because the auditors' actions in these cases had serious consequences on company's stakeholders; e.g. investors' wealth is jeopardized. For this reason, many regulatory bodies and academic researchers have put a lot of scrutiny on how to improve auditing quality, including by adding more restricting standards by authoritative bodies (Nagy and Cenker, 2007; Jackson, Moldrich and Roebuck, 2008) and by empirical studies that investigated audit quality influencing factors (De Angello, 1981; Jeong and Rho; 2004; Carlin, Finch and Laili, 2009). Based on these literatures, audit quality has been defined as the auditor's capability of finding out any probable client's violation in accounting system, and its ability to declare the discovered violation in the audit report (DeAngelo, 1981).

Several previous studies have investigated the factors that determine audit quality by giving more attention to client companies' specific characteristics that may lead to better auditing quality (Lam and Chang, 1994; Lee, Stokes, Taylor and Walter, 2003; Chen, Lin and Zhou, 2005; Jain and Martin, 2005). In addition, other studies examined determinants that are outside the auditing and clients firms' control, such as the rules imposed by regulatory bodies (Jackson, Moldrich and Roebuck, 2008; Boon, McKinnon and Ross, 2008; Kim and Yi, 2009).

Then, in relation to the sample of the study, many studies have been done on the field of Islamic banks and have covered these kinds of institutions from different views. These studies tend to be more on banks' operations and governance (Satkunasingam and Shanmugam, 2004; Sufian, 2007; Dusuki and Abdullah, 2007). However, none of these researches have been conducted on audit quality in Islamic banks. 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

Financial statements are considered as the central point of conveying the main information of the financial position of any economic unit and it is a very important tool to discharge the accountability of management to shareholders and other stakeholders. This accountability is even more important in banks because of its financial operations that are considered at the heart of the economy in the capitalist system. The essence of these banks are to secure and produce necessary funds to a large category of stakeholders (investors, creditors, depositors, loan recipients, etc) (Dimitropoulos and Asteriou, 2009).

Stakeholders' perceptions towards Islamic banking in Malaysia is far more critical, mostly due to the fact that Islamic banks exists in a dual-banking system. Hence, they are in competition with the long established interest-based conventional banks (Dusuki, 2008).Islamic banks have an additional responsibility that is not only directed towards its shareholders, but to other stakeholders and the community because of its socio-economic purposes and its moral foundation which is based on religious principles and Muslim customers' beliefs (Satkunasingam and Shanmugam,

2004). This accountability, of Islamic banks toward the community, is partially achieved through the financial reporting (Baydoun and Willet, 2000; Lewis, 2001, Maali, Casson and Napier, 2006).

In this context, auditors have an additional obligation to be consistent with Islamic banks' purposes through ensuring the quality of its financial statements, that is in turn guaranteed by a higher level of audit quality (Lee, Stokes, Taylor and Walter, 2003; Hussainey, 2009). As a result, in order to fulfill the auditors' role, a high standard of audit quality is required particularly in Islamic banks to meet its foundation objectives and raised emblems. However, there is limited literature on audit quality in Islamic banks. This could be because of the difficulties that accompanies the measurement of audit quality; unless the researcher has access to audit information internal to the audit firm.

Nonetheless, indicators of audit quality may be used to gauge its level. In this study they are known as audit quality influencing factors (AQIF), which can be defined as a set of factors that may enhance audit quality like audit firms' size, corporate governance, audit tenure, client firm size (Hoitash, Markelevich and Barragato, 2007; Lai, 2009; Wahab, Zain, James and Haron, 2009).

From the above discussion, the aim of the study is to investigate the difference between AQIF of Islamic banks and conventional banks in Malaysia. In addition the study also determines whether there has been an improvement in AQIF in the Malaysian banks in 2009 as compared to 2006. The purpose of the study is further refined in the next section.

1.3 PURPOSE OF THE STUDY

This study analyses annual reports for the year 2006 and 2009 of the Malaysian banks listed in Bursa Malaysia Berhad, to obtain an indication of their auditing quality. For this, three objectives were developed, as follows:

1. To analyze the audit quality influencing factors (AQIF) in Islamic banks.
2. To investigate whether there is a difference in terms of audit quality level, based on these factors, between Islamic and conventional banks.
3. To determine if there has been an improvement in AQIF in 2009 as compared to 2006 in Malaysian banks.

Based on these research objectives, this study attempts to provide answers to the following research questions:

1. What is the extent of audit quality influencing factors in Islamic banks in Malaysia?
2. Is there a difference in the audit quality influencing factors between Islamic and conventional banks?
3. Is there an improvement in audit quality influencing factors of Malaysian banks in 2009 compared to 2006?

1.4 MOTIVATION OF THE STUDY

Audit quality is crucial to Islamic banks. This can be explained from the view that audit quality is a necessary factor in preserving the quality of Islamic bank's financial reporting. Thus, when the accuracy of the financial statement is preserved, through a higher level of audit quality, it will allow the Islamic banks to be seen as dependable in the market because of its accurate and reliable declared information. Therefore, this study is motivated by the fact that there is a need to get an indication of the level of

audit quality in these institutions due to the importance of audit quality in Islamic banks' financial statements being perceived as being reliable and free of material misstatement by their stakeholders.

This study is also motivated by the intention to assist the banks in enhancing their practices, particularly in terms of financial reporting. This is because, indicating the factors that may improve audit quality could help the banks themselves in discharging their obligation to shareholders, stakeholders and the Ummah. AQIF which are lacking in Islamic banks may be discovered through conducting this research. This may allow the Islamic banks to focus and direct its effort on the weaker points which may allow these institutions to improve their practices.

Lastly, this study is motivated by the fact that there is a lack of research in this area, as motivated before. Even though there are studies on Islamic banks, there is dearth of literature on audit quality in Islamic banks, specifically in relation to the context of Malaysia. Therefore, this study may be considered a preliminary study which uses simple indicators to determine the potential audit quality of Islamic banks in Malaysia. In conclusion, this study was also motivated by the necessity to fill the gap in the literature in this area of research.

1.5 CONTRIBUTION OF THE STUDY

This study hopes to contribute towards the society in the following ways:

Firstly, this study's sample is banks in Malaysia. As the banking system is fundamental to the strength and stability of a country's economy, it is crucial that proper reporting takes place in order to ensure transparency and accountability. This true and fair reporting can be assured by a good quality audit. Hence attaining an indication of the audit quality in Malaysian banks is important; it becomes even more

vital when there is lack of studies and literature on audit quality in banks, particularly on Islamic banks in Malaysia.

Secondly, it must be highlighted that investigating the audit quality in Islamic banks is of particular importance and necessary to the Muslim community. This is because, the reputation of Islamic banks are connected to the reputation of the religion itself. Since these banks are established on the basis of the Shariah, it is essential that they are seen to be transparent and accountable. Portraying transparency and fulfilling accountability can be partly achieved through the financial reports. Again, the financial reports may be considered reliable if they undergo a quality audit. Thus, once again it is dire to get some indication of audit quality in these banks.

Furthermore, this study contributes by using several audit quality influencing factors as indicators of audit quality. This, hopefully, is an improvement from prior studies, which only used one variable as a proxy of audit quality. Therefore, a slightly more comprehensive measure is used to indicate audit quality in this study.

This study may be useful to the shareholders, particularly of Islamic banks, as they may want to know whether the audit quality in these banks are good, or at least comparable to those of conventional banks. Hence, this study is able to provide an indication of the audit quality of Islamic banks in comparison to their conventional counterpart.

Moreover, this study may also be beneficial to the Islamic banks themselves as some of the elements that may enhance audit quality are under the control of the banks. Therefore, based on this study, the banks may be made aware of certain areas that may need improvement.

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

1.6 ORGANIZATION OF CHAPTERS

The contents of this dissertation are organized into six chapters, which are as follows:

Chapter One: Introduction: This chapter presented a brief discussion of the study's background, statement of the problem, general purpose and specific objectives of the study, research questions, motivation for the research and contribution of the study.

Chapter Two: Literature Review: This chapter provides extensive prior literature review in the sphere of audit quality determinants. The researcher provides some focus on past studies undertaken in the context of the emerging economies as the current study is conducted in a developing country, Malaysia. The researcher also includes a review of literature in developed countries and Asian countries as well. Finally, this chapter highlights some prior studies on auditing in Malaysia and other literatures related to the study.

Chapter Three: Theoretical Framework: This chapter discusses the theoretical foundation of the study. To the best of my knowledge there are very limited studies that have used theory directly in audit quality literature. Nonetheless, many prior studies mentioned that client firms endeavor to hire more qualified auditors in order to reduce agency costs. As a result, the researcher expects to provide a discussion on an applicable theory for this study, which is agency theory. Also, since the objective of the study is to compare between Islamic and conventional banks in terms of audit quality influencing factors, this study utilizes the concept of Islamic accountability which is relevant to this research. Relevant hypotheses are also developed in this chapter.

Chapter Four: Research Method: In chapter four, sample selection procedures are discussed as well as sample size. Data sources are also explained. The AQIF items

are discussed in further detail. Furthermore, statistical testing methods such as descriptive statistics, T-test, Mann-Whitney U, independent sample T-test and Paired sample T-test are stated as being utilized in the study.

Chapters Five: Research Findings: Results of the study are presented in this chapter. Results are shown in table form so that readers can understand easily. The analyses of the findings are discussed in this chapter.

Finally, Chapter Six: Conclusion, Limitations of the study, and suggestions for future research: Results of the study are discussed further in terms of its implications and recommendations. Conclusion of the findings is carefully elaborated (conclusion and recommendation section). Finally, before future research areas are provided, the study's limitations are discussed, then suggestions for future research are made before the study concludes.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

Many researchers have contributed to the literature regarding the issue of auditing quality. The studies mainly focused on a number of factors that have influence on the level of auditing quality. Most of these studies, that have been conducted in this area of research, reported findings that auditing firm size, corporate governance, earnings management, and audit fees had some impact on auditing quality. These studies have used different methodologies to achieve its objectives. For example, Ballesta and Meca (2005) analyzed information obtained from corporate annual reports; Ismail, Haron, Ibrahim and Isa (2006) used questionnaire to obtain information from respondents; and Nagy and Cenker (2007) conducted interviews.

Even though there are numerous studies on audit quality, there are very few studies that have specifically researched on the banking institutions in Malaysia specifically, in terms of their audit quality. Nevertheless, prior to discussing the gap in the literature in further detail, this chapter of the research reviews literature in the area of audit quality. Particular attention is given to the factors documented in prior literature that influence audit quality. As a result, this part will start with studies on Islamic banks and literatures on auditing in Malaysia in general. The next section will go more specifically by discussing previous studies on audit quality in both developed and Asian countries and it looks as well to the studies that have been conducted in Malaysia. Studies on auditing in Malaysia and other literatures related to the objective of the study (DeAngelo, 1981; Elitzur and Falk, 1996; Abdullah, Ismail and

Jamaluddin, 2008) will be presented in following section. Finally, section three concludes this chapter.

2.2 STUDIES ON ISLAMIC BANKS

Since the aim of the current study is to compare between Islamic and conventional banks in terms of AQIF, this section will review prior studies on Islamic banks in order to obtain an overview of these studies and possibly identify an area for their extension.

In relation to Islamic banks, Abdel Karim (1990) has studied the issue of Sharia supervisory board and external auditor independence in a different setting, i.e. Islamic banks. This study was theoretical in nature, in order to investigate the approach for enhancing concepts and objectives of financial accounting and its needs. In this respect, the author argued that auditors' independence stems from their religious commitments. In addition, Abdel Karim (1990) pointed out that this commitment has a very effective impact on auditors in terms of avoiding any management influence on his decision to report or declare any potential misstatement.

On the other hand, Sufian (2007) investigated in their research the difference between the domestic and foreign Islamic banks in terms of efficiency. This study used the Data Envelopment Analysis methodology, which permits the researcher to measure the efficiency of the Islamic banks in easier and clearer manner. In doing so, this paper selected all the existing Islamic banks in the Malaysian financial market from 2001 to 2004. The findings indicate that Islamic banks efficiency has decreased in 2002 to some extent and recovered in 2004. However, contrary to prior research Sufian (2007) found that the domestic Islamic banks are better than foreign Islamic banks.

Unlike the previous studies, Dusuki and Abdullah (2007) investigated the most important aspects that encourage customers to transact with Islamic banks especially in a dual banking system like Malaysia. This study collected data through questionnaires involving a sample of 750 respondents from four different parts in Malaysia. Dusuki and Abdullah (2007) found that customers' satisfaction is often and mainly depends on Islamic banks' services' quality. The quality of services includes factors like treating customers with courtesy and respect; staff ability to convey trust and confidence; efficiency and effectiveness in handling any transactions; and knowledge and preparedness in providing solutions and answers concerning Islamic bank's products and services.

From another perspective, the studies that have scrutinized on Islamic banking field, have looked to these kinds of institutions from different point of research like Satkunasingam and Shanmugam (2004) who investigated the existing status of corporate governance in Malaysia and how it operates in Islamic banking. This paper highlighted as well the need of more detailed disclosure and more information to be provided to Islamic banks' clients regarding the degree of their risk exposure.

Similar to Sufian (2007), Mokhtar, Abdullah and Alhabshi (2008) examined the efficiency of Islamic banks and Islamic windows in Malaysia. In this respect, the study analyzed the annual reports of two full-fledged Islamic banks, 20 Islamic windows and 20 conventional banks. The findings revealed that the competitive level of Islamic banks have noticeably increased in the period from 1997 to 2003 and full-fledged Islamic banks were more resourceful than Islamic windows. However, the average Islamic banks efficiency was lesser than conventional banks. Furthermore, local banks were less efficient than foreign banks.

In another study, Khan and Bhatti (2008) investigated the new and current appearing Islamic banking sector in order to guide the worldwide point of view regarding these kinds of institutions, development, infrastructures and supporting institutions in recent years. In doing so, this study, by depending on annual reports, looked to Islamic banks paradigm of borrowing, lending, and investment in order to measure the ethicality and growth of these institutions. For this aim, the study selected 10 different Islamic banks from different countries in the Islamic world, including Malaysia. The study's findings shows that Islamic banks have witnessed a noticeable progress; and the Middle East, South Asia and the Indian Subcontinent are in the hub of this noticeable progress. In addition, this study found that conventional banks and Western investors are showing an intention to invest in these kinds of institutions. However, Islamic banks are facing some teething problems in terms of its corporate governance, management, and competitive Islamic banks accounting standards.

In conclusion, it seems from reviewing prior studies on Islamic banks that there is a gap in the literature regarding the issue of audit quality in Islamic banks because, to the best of my knowledge, no previous study have related the issue of audit quality in these kinds of institutions. In trying to cover this gap the next section will review prior literature on audit quality.

2.3 AUDITING IN MALAYSIA

Wahab et al. (2009) stated that auditors in Malaysia are restricted by auditing standards and requirements similar to many other countries in the world. However, the 1965 Malaysian Companies Act scrutinizes on auditors' independence, gives auditors authority to attend client company meetings, and offer auditors sufficient accessibility to their client company's accounting records and information (Ali, Haniffa and