



**THE EXTENT OF AUDIT REPORT LAG AND  
GOVERNANCE MECHANISMS IN THE ISLAMIC  
BANKING INSTITUTIONS IN MALAYSIA**

**BY**

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## ABSTRACT

Timeliness of financial reports is a mirror of up-to-date financial information which is considered as the main driver for useful financial reports. The extent of audit report lag is found to be the most observable indicator for timely financial reports because financial reports cannot be published without being audited and verified (i.e. true and fair view) by the external auditor of the firm. This study examines the association between the extent of audit report lag and governance mechanisms in the Islamic banking institution in Malaysia. The governance mechanisms are board independence, audit committee size, expertise and meeting and *Shari'ah* committee expertise. Consequently, the study employed agency theory to explain the hypotheses development. From 112 observations of the study sample, the findings of panel data analysis indicated that the extent of audit report lag is significantly associated with audit committee expertise, audit committee meeting and the size of Islamic bank. Board independence, audit committee size and *Shari'ah* board expertise were found to have a weak negative association with the extent of audit report lag, while busy-season variable was found to have a weak positive relationship with the extent of audit report lag. Apart from contributing to the literature on corporate reporting and governance system, this study provides a feedback to the regulatory bodies on the past and current process of financial reporting practices and governance practices in the Islamic banking institution in Malaysia.

## خلاصة البحث

سرعة توقيت تقرير الشركة هو انعكاس عن تحديثات المعلومات المالية و التي تعتبر دافع أساسي إلى الاستفادة من تقرير الشركة المالي. مدي فارق التوقيت الزمني الموجود بالتقرير المراجع المحاسبي يعتبر من أهم العوامل التي تؤثر علي الاستفادة من تقرير الشركة المالي لأنه لا يمكن إصدار التقارير المالية للشركة دون مراجعتها و التحقق منها ( الصورة الحقيقية و العادلة) من قبل المدقق المحاسبي. تهدف الدراسة إلى فحص العلاقة بين التوقيت الزمني لتقرير المراجع المحاسبي وآليه حوكمة الشركات بالمصارف الاسلامية بماليزيا. آليه حوكمة الشركات في هذه الدراسة هي استقلالية مجلس الإدارة , حجم لجنة المراجعة , خبرة لجنة المراجعة و اجتماع لجنة المراجعة و خبرة مجلس الشريعة. بناء علي هذا استخدمت الدراسة نظرية الوكالة لتوضيح تطوير النظريات. من خلال 122 ملاحظة من التقرير المالي السنوي تشير النتائج إلى أن فارق التوقيت الزمني بتقرير المراجع المحاسبي مرتبط كثيرا مع خبرة لجنة المراجعة و اجتماع لجنة المراجعة و حجم المصرف الاسلامي. أما عن استقلاليه مجلس الإدارة و حجم لجنة المراجعة وخبرة مجلس الشريعة فعلاقتهم وجدت سلبية وضعيفة في حين أن موسم الازدحام وجد بعلاقه إيجابية ولكنها ضعيفه. كما أنه تقوم الدراره بالمساهمة للمعرفة في مجال الحوكمة و تقارير الشركات, هذه الدراسة أيضاً تقدم نتائج إسترجاعية إلى المنظمات الادراية حول الممارسات القديمة و الحاضرة لسير عملية التقارير الماليه و الحوكمة للمصارف الاسلامية بماليزيا.

## APPROVAL PAGE

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## DECLARATION

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## LIST OF ABBREVIATIONS

ARL	Audit Report Lag
BIMB	Bank Islam Malaysia Berhad
BNM	Bank Negara Malaysia
GMs	Governance Mechanisms
GP1-i	Guidelines on Corporate Governance for Licensed Islamic Banks
GP8-i	Guidelines on Financial Reporting for Licensed Islamic Banks
IBs	Islamic Banking Institutions
OCED	Organisation for Economic Co-Operation and Development
SGF	<i>Shari'ah</i> Governance Fraemwork

# **CHAPTER ONE**

## **INTRODUCTION**

### **1.1 BACKGROUND OF THE STUDY**

In the capital market, especially in developing economies, annual report is irrefutably an important source that provides information concerning an institution. Since the users of annual reports have no access to institution's accounting records, they depend heavily on the information disclosed in the annual report when making decisions (Owusu-Ansah, 2000). Hence, the purpose of annual report as a communication tool is to represent information about the economic and non-economic health condition, the forecasts of the institution's goals in the future and other information that is useful for those who's having reasonable rights to such information for making decisions. In this case, the annual report is not only meant to fulfil the legal requirements, but also as means to influence the decision making. From this standpoint, such a decision making would be influenced by the extent when the financial reports are produced.

Soltani (2002) classified the extent of financial reports into early (timely), on time or late (delay). Consequently, it can be said that producing timely information through financial reports could provide users with useful decisions making. Timeliness is a mirror of up-to-date information which has been categorized as a key driver for useful financial reports by Financial Accounting Standard Board (2010), as part of the conceptual framework of financial reporting requirements. Timeliness is defined as the availability of information on time to decision makers before impairing its value in influencing their decision making. In other words, the greater benefit of

useful financial information is diminished when the production of financial reports takes a long time to be released to the public (Al-Ajmi, 2008).

On the other hand, a delay in providing financial reports could lead to the issue of information asymmetry risk. Such risk of information asymmetry will increase the level of uncertainty related to investment decisions (Ashton, Graul, & Newton, 1989), and also increase the information dissemination among the stakeholder. As a result, those 'well-informed' investors can exploit (trade on) their private information at the expense of 'less-informed' investors (Jaggi & Tsui, 1999). Therefore, the occurrence of leak, rumors and insider trading can affect the firm performance and efficiency in the capital market (Owusu-Ansah, 2000).

Given the importance of timely financial reports in the capital market, previous studies have identified that the audit report lag (ARL) is the most observable indicator for the production of timely financial reports (Ashton, Willingham, & Elliott, 1987; Gilling, 1977; Owusu-Ansah, 2000; Asri, 2005). This is because, the financial reports cannot be released without being audited and verified (for its true and fair view) by the external auditors. Abdullah (2006) reported that non-compliant companies in Malaysia with the requirement of financial reports submission in Bursa Malaysia, waited up to 146 days for their audited financial reports to be produced. Afify (2009) also indicated that the extent of ARL of listed companies in Egypt is 67 days. A recent study by Al Daoud, Ismail, and Lode (2015) found that the external auditors in Jordan took about 10 weeks to produce audited financial reports.

The extent of ARL is measured based on the time lag from the date of financial year-end to the signature date of audit report (Davies & Whittred, 1980)<sup>1</sup>. Meanwhile, the importance of ARL has motivated past studies to investigate number of factors

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<sup>1</sup> Since, the extent of financial reports (as classified by Soltani, 2000) has is a direct relationship with the extent of ARL, the time lag of ARL also can be classified into timely, on time or late (delay).

that could influence the extent of ARL such as profitability, age and size of the company, types of audit firm, audit qualifications and busy season period. Other factors like corporate governance mechanisms have also been investigated. For example, board of directors, audit committees and internal audit functions were used as explanatory variables to test their association with the extent of ARL in different countries (Afify, 2009; Hashim & Rahman, 2010; Mohamad Naimi, Shafie, & Nordin, 2010; Nelson & Shukeri, 2011; Apadore & Noor, 2013; Wan-Hussin & Bamahros, 2013; Sultana, Singh, Der Zahn, & Mitchell, 2015). More specifically, these studies examined the characteristics of corporate governance mechanisms such as size, expertise, meeting and independence of board of directors or/and audit committee in influencing the extent of ARL.

Sharma, Boo, and Sharma (2007) explain how the level of corporate governance mechanisms practices would influence the extent of ARL. According to the authors, effective corporate governance mechanisms reduce the business risks, in turn, it will influence the audit risk assessment and that the work of external audit will be reduced resulting in timely audited financial reports. In other words, if the external auditor completes his/her work on timely manner, the audited financial reports will be issued on time, or vice versa. Hence, the relationship between the extent of ARL and corporate governance is seen as a reflection of effective corporate governance mechanisms (Nelson & Shukeri, 2011) and efficiency of external auditor (Afify, 2009).

Nevertheless, an observation of the existing empirical studies shows that the extent of ARL has been well studied in both developed countries and developing countries. It should be noted that the issue of ARL has not received any attention in the context of Islamic Banking Institutions (IBs). In addition, there is lack of past



studies that have investigated the association between the extent of ARL and corporate governance mechanisms in the financial institution, not to mention IBs. Therefore, there is a gap in the current literature that the current study intends to fill.

## **1.2 STATEMENT OF THE PROBLEM**

IBs is an alternative banking system that is designed to provide financial services in compliance with the principles of *Shari'ah* (Ariff M., 1988). The central feature of *Shari'ah* principles is the prohibition of interest “*riba*”, which IBs need to ensure that its financial services are free from interest (Ghayad, 2008).

Despite the provision of *Shari'ah* principles, the IBs have recorded a remarkable ongoing growth and development over the years. According to Ernst and Young (2014) in the “World Islamic Banking Competitiveness Report 2014” the current international Islamic banking assets have reached USD 778 billion, with Cumulative Annual Growth Rate of 17 per cent from 2009 to 2013. In Malaysia, the trend of growth has not gone unnoticed, as IBs contributed by 16.7 per cent globally. At the end of 2013, the total assets of IBs was recorded at RM 487 billion, representing about 22 per cent of the total institutional banking assets in Malaysia.

The achievement recorded above, further indicated that the issue of timely of financial reports is highly important to the IBs and its capital market. This is due to several reasons. Firstly, most of IBs are located in developing countries. Previous studies such as (Owusu-Ansah, 2000; Owusu-Ansah & Leventis, 2006; Al-Ajmi, 2008; Che-Ahmad & Abidin, 2009) emphasis on the importance of providing timely financial reports since information in developing markets is relatively limited and has a longer time lag. Therefore, greater benefits would be derived from timely financial reports for decision-making in these developing markets.

Secondly, financial reports may help to mitigate agency problem (i.e. information asymmetry) by bridging the gap between users and agent. The fact that the activities in the banking institutions (including IBs) are categorized by the complexity and higher risks associated with their operations, which increases the risk of information asymmetry and reduces the stakeholder's capacity to monitor and evaluate the bank's performance (Turlea, Mocanu, & Radu, 2010).

Moreover, another form of agency problem arises from a conflict between agent and principal. For example, the management of IBs may face conflict of interests with its investment depositors (e.g. investment account holders), as the capital value of and returns on investment deposits are not fixed and guaranteed, and that the losses will be borne by the holders of investment deposits (Archer & Karim, 2007). From this stand point, the issue of information asymmetry risk remains of greater concern when it is combined with conflict of interests in the IBs. Therefore, greater benefits of timely financial reports (measured by ARL) would help to mitigate agency problems.

Thirdly, unlike conventional banks, the operation of IBs is exposed to another type of risks namely *Shari'ah* non-compliance risks. According to Shari'ah Governance Framework (2010) "*Shari'ah* non-compliance risks refer to the possible failures to meet the obligation of *Shari'ah* principles or possible incidences of *Shari'ah* non-compliance". In this case, IBs is required to establish governance mechanisms, such as *Shari'ah* committee, *Shari'ah* audit, *Shari'ah* review and *Shari'ah* risk management, to reduce the level of *Shari'ah* non-compliance. Thus, with these governance mechanisms the IBs are expected to be able to continue its operations and activities effectively without exposing to unacceptable level of risks. However, it is also expected that *Shari'ah* non-compliance risks combined with

financial risks would increase the time spent to perform the *Shari'ah* audit, subsequently affect the extent of ARL in the IBs.

Finally, the reported failures and frequent issues of IBs such as Ihals Finans of Turkey, Islamic Bank of South Africa, Islamic Investment Companies of Egypt, Dubai Islamic Bank, and the case of Bank Islam which is considered as the model of Islamic banking in Malaysia justify the need for further empirical investigation in this area (Ali, 2007; Askari, Iqbal, & Mirakhor, 2009; Awad, 2011; Thajudeen, 2013). Studying the Malaysian context provide a room for the research to be conducted as it is one of the leading nations in the Islamic banking and finance with highest number of IBs. The current study aims to examine the extent of ARL in the IBs in Malaysia.

### **1.3 RESEARCH OBJECTIVES**

The main purpose of the study is to provide further understanding on the association between the extent of ARL and governance mechanisms (GMs) in the IBs in Malaysia. In this study, GMs denote board independence, audit committee size, audit committee expertise, audit committee meeting and *Shari'ah* committee expertise.

Specifically, the aims of the study are stated as follows:

- 1- To examine the extent of ARL in the IBs in Malaysia.
- 2- To examine the extent of GMs in the IBs in Malaysia.
- 3- To examine the association between the extent of ARL and GMs in the IBs in Malaysia.

### **1.4 RESEARCH QUESTIONS**

In order to achieve the above research objectives, three research questions are to be answered:

RQ1- To what extent does ARL exist in the IBs in Malaysia?

RQ2- To what extent do the GMs exist in the IBs in Malaysia?

RQ3- Is there any association between the extent of ARL and GMs in the IBs in Malaysia?

## **1.5 MOTIVATION OF THE RESEARCH**

This study is motivated by the fact that ARL is an ongoing topic, and the fact that changes in the structure of business such as corporate reporting requirements or/and corporate governance requirements would influence the extent of ARL. Hence, different regulatory environment provides a venue for further studies in this area.

Furthermore, previous studies have called for further research in this area: (1) Ashton et al. (1989) and Owusu-Ansah and Leventis (2006) recommended further studies to focus on a single industry orientation such as the financial industry, and (2) Henderson and Kaplan (2000) suggested that further research can employ a panel data analysis to analyze the extent of ARL. A panel data analysis could show the long term association of corporate governance mechanisms on the extent of ARL (Nelson & Shukeri, 2011). More importantly, to date, there are only two studies that have addressed the issue of ARL in banking institutions and only one study used panel data analysis (El-Bannany, 2008; Henderson & Kaplan, 2000). Hence, conducting a research on the extent of ARL in the IBs in Malaysia using panel data analysis would be useful for further understanding on the subject matter.

## **1.6 SIGNIFICANT OF THE STUDY**

It is hoped that the findings of this study would offer several implications in the following way: first, despite the growth of IBs in the recent years, academics and

researchers have paid little attention on the issue related to the process of financial reporting and governance system in the IBs. Even though *Shari'ah* compliance is very important to the operation of the IBs, at the same time, stakeholders' wealth (e.g. shareholders, investors, customers, etc.) need to be secured through minimizing the agency problems such as information asymmetry. Hence, the current study is hoped to be a preliminary effort to investigate the GMs in relation to the ARL.

Second, the study will provide additional knowledge to the existing literature on corporate reporting and corporate governance, particularly in the context of IBs. More importantly, the findings of the study will be beneficial to Malaysia in particular for being one of the leading nations in Islamic banking and finance industry, and to other countries that offers Islamic banking services. As the findings of this study provides feedbacks with regard the past and current practice of financial reporting process and governance mechanisms practices in the IBs in Malaysia. Therefore, it is hoped that policy makers such as the Bank Negara Malaysia (BNM) may find the results of this study useful for future financial reporting and governance guidelines.

## **1.7 SCOPE OF THE STUDY**

The study covers all commercial IBs that are licensed under the BNM. As at the end of 2014, there are sixteen (16) licensed IBs operating in the Malaysian market. In this study, all the 16 licensed Islamic banks are examined for seven (7) years period starting from 2008 to 2014. On the other hand, the study does not include any other financial institutions such as conventional banks, licensed insurance companies and Takaful. This is because these IBs have different regulatory requirements.

The GMs in the chosen IBs are composed of different mechanisms, including the board of directors, audit committee, *Shari'ah* committee, internal audit, *Shari'ah*

audit and external audit. However, this study only covers independence of the board of directors, audit committee attributes (size, expertise and meeting) and *Shari'ah* committee expertise, which are explanatory variables to investigate their association with the extent of ARL in the IBs in Malaysia.

## **1.8 ORGANISATION OF THE STUDY**

The study is organized in seven chapters. Chapter one represents the introduction of the study. This chapter serves as an introductory chapter that briefly highlights the background, problem statement, research objectives and research questions, motivations, significance and scope of the study. Chapter two is the institutional background. The institutional background chapter provides a brief foundation to understand the meaning of corporate and *Shari'ah* governance, the historical development of IBs in Malaysia as well as the regulatory requirements for governance mechanisms and financial reporting of IBs in Malaysia. Chapter three shows the literature review of past studies regarding the extent of ARL and the identification of the gap in the literature. Chapter four deliberates on the theoretical framework and hypotheses development of the study. The chapter explains the relevance of agency theory for IBs and its relation with the extent of ARL in order to develop the hypotheses, while Chapter five explains the study design, statistical models and operational variables measurement. Chapter six provides analysis and discussion of the collected data. Chapter seven is a summary of the overall study. This chapter contains a brief summary of the findings, limitations and contributions of the study.

## **1.9 SUMMARY OF THE CHAPTER**

This chapter briefly described the introduction of this dissertation. The chapter also explained the research objectives and research questions that to be achieved. The significant of the study is also highlighted in this chapter. The following chapter will discuss the institutional background of the current study.

## CHAPTER TWO

### INSTITUTIONAL BACKGROUND

#### 2.1 INTRODUCTION

The chapter discusses the institutional background of IBs in Malaysia. The second section provides a brief overview on the IBs including its development. The third section of the chapter presents a discussion regarding the development of IBs in Malaysia. The fourth section provides a brief definition on corporate governance followed by its relation to IBs. Finally, the chapter also briefly discusses the BNM guidelines of governance system and financial reporting disclosure requirements.

#### 2.2 AN OVERVIEW OF IBS

It is said that the existence of IBs has a notable addition to the global financial markets and its emerging root can be traced back to the 1960s when Mit Ghamr Savings Bank was formed in Egypt in 1963. IBs is understood to be an alternative system to the conventional banking institution. Basically, IBs is designed to provide financial services that are in compliance with the fundamental principles of *Shari'ah* (Ariff, 1988). *Shari'ah* principles are derived from the *Quran*<sup>2</sup> and *Sunnah*<sup>3</sup>, while interpreted by Islamic jurisprudence known as *fiqh*<sup>4</sup>. The central feature of *Shari'ah* principles is the prohibition of *riba*, which the IBs need to ensure that its financial services are free from *riba* (Ghayad, 2008).

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<sup>2</sup> *Quran* is the revelation book of God (Allah) that given to His prophet Mohammed (S.W.A.T) to serve as a foundation framework for Muslims in their lives.

<sup>3</sup> *Sunnah* refers the way of life (*sira*) of the Prophet. It stands for the habits, behaviour, practices and sayings of the Prophet. The *Sunnah* is transmitted as Hadith. Hadith is a form of report about the *Sunnah* that delivered through a dependable chain of transmitters.

<sup>4</sup> *Fiqh* is known as the production and effort of Muslim scholar in order to interpret the primary sources.