



THE PERCEPTIONS OF DEPOSITORS ON THE  
AUDITOR'S REPORT OF ISLAMIC BANKS

BY

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## **ABSTRACT**

This dissertation examined depositors' perceptions of the assurance of financial statements including Shariah compliance, particularly in terms of the auditor's report. The concern is whether the Islamic Banks' (IBs) audit reports provide ample reference that the financial statements of IBs are in accordance with the financial reporting framework as well as assurance on Shariah compliance. By proposing an expanded auditor's report based on suggestions found in the literature, the dissertation identified the potential application of the expanded auditor's report within the Islamic banking context. More importantly, the proposed auditor's report adopts no wordings that could be misconstrued as increasing the auditor's responsibility or exposure to legal liability. As the study was exploratory, the experiments were conducted to final-year accounting undergraduates as the focus group that could provide preliminary insights into the overall stakeholders' perceptions. The students, who were also depositors in IBs, were selected from two public universities in Malaysia. The findings showed significant differences in the students' perceptions of the proposed expanded auditor's report as compared to the existing auditor's report. Secondly, it also proved that certain information could significantly enhance perceptions of the IBs' auditor's report. Finally, pertaining to Islamic education background, the depositors did not significantly differ in their perceptions of both reports. While the study did not find that general Islamic education background affected users' perceptions of the auditor's report, it provided an opportunity for further evaluations of other stakeholders' perceptions, especially those with different educational background and experience. It is believed that this exploratory study could provide useful insights for IB auditors and management in their decision making, as well as the regulators, to meet users' demands for clear audit reports and increase the clarity and information of Shariah compliance.

## خلاصة البحث

تناقش هذه الأطروحة تصورات المودعين لبيانات التأمين المالي، ويشمل ذلك الأحكام الشرعية، ولاسيما في تقرير مراقب الحسابات. ومما يثير القلق هو ما إذا كانت تقارير مراجعة الحسابات في البنوك الإسلامية تقدم مراجع وافرة في البيانات المالية وفقا لإطار التقارير المالية، فضلا عن التأمين في الأحكام الشرعية. ومن خلال اقتراح التقرير الموسع لمدقق الحسابات المستند على اقتراحات وجدت في البحوث السابقة، حددت هذه الأطروحة التطبيقات المحتملة للتقرير الموسع لمدقق الحسابات ضمن سياق العمل المصرفي الإسلامي. والأهم من ذلك أن التقرير المقترح لمراقب الحسابات لا يعتمد على صيغ يساء فهمها، حيث رفعت من مستوى مسؤولية مدقق الحسابات أو تعرضه لمساءلات قانونية. وتعد هذه الدراسة استطلاعية، لذلك أجرت تجارب في طلاب السنة الأخيرة في المرحلة الجامعية لقسم المحاسبة، على اعتبار أن هذه المجموعة يمكن أن تركز على تقديم تصورات أولوية في التصورات العامة لأصحاب المصالح في الشركات. وقد تم اختيار الطلبة المودعين أيضا في بنوك إسلامية من جامعتين حكوميتين في ماليزيا. وأظهرت النتائج فروقا ذات دلالات إحصائية في تصورات الطلبة من التقرير المقترح والموسع لمراجع الحسابات من خلال مقارنة التقرير الموجود لمدقق الحسابات. كما أثبتت النتائج أيضا أن بعض المعلومات يمكن أن تعزز بشكل كبير تقرير مدقق الحسابات في البنوك الإسلامية. وأخيرا، فيما يتعلق بالتربية الإسلامية، فإن المودعين لا يختلفون كثيرا في تصوراتهم لكلا التقريرين. في حين لم تجد الدراسة أن الخلفية العامة للتربية الإسلامية لها تأثير على تصورات المستخدمين في تقرير مدقق الحسابات، حيث أتاحت الفرصة لمزيد من التقييمات لتصورات أصحاب المصلحة في الشركات، لا سيما أولئك الذي لديهم خلفيات تعليمية مختلفة وخبرات واسعة. ويعتقد أن هذه الدراسة الاستطلاعية يمكن أن توفر معلومات مفيدة لمراجعي الحسابات والإدارة في البنوك الإسلامية لاتخاذ قراراتها، فضلا عن المنظمين، وذلك لتلبية طلبات المستخدمين لتقارير مراجعة الحسابات ورفع مستوى المعلومات والتوضيحات المطابقة للشريعة الإسلامية

## 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 research paper for the degree of Master of Science in 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.

Amirul Hafiz Mohd Nasir

Signature.....

Date.....

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Date

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## LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organizations of Islamic Financial Institutions
AIA	American Institute of Accountants
AIBIM	Association of Islamic Banking Institutions in Malaysia
AICPA	American Institute of Chartered Public Accountants
ASA	Australian Shareholders' Association
BNM	Bank Negara Malaysia
CFA	Chartered Financial Analyst
CFO	Chief Financial Officer
CPA	Chartered Public Accountants
GAAP	General Acceptance Accounting Principles
IAASB	International Auditing and Assurance Standards Board
IBA	Islamic Banking Act 1983
IBs	Islamic Banks
ICR	Internal Control Report
IFAC	International Federation of Accountants
IFIs	Islamic Financial Institutions
IFRS	International Financial Reporting Standards
IUM	Islamic University Malaysia
ISA	International Standard on Auditing
IOSCO	International Organization of Securities Commissions
KWA	Kruskal-Wallis one-way analysis of variance by ranks
MASA	Malaysian Approved Standards on Auditing
MBA	Master in Business Administration
MIA	Malaysian Institute of Accountants
NYSE	New York Stock Exchange
PCAOB	Public Company Accounting Oversight Board
PTPTN	National Higher Education Fund Corporation
SAI	Supreme Audit Institution
SAP	Standard Accounting Procedures
SAS	Statement of Auditing Standards
SEC	Securities Exchange Commission
SSB	Shariah Supervisory Board
UK	United Kingdom
UKM	Universiti Kebangsaan Malaysia
US	United States
VPA	Verbal Protocol Analysis

# **CHAPTER 1**

## **INTRODUCTION**

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

The total sum of Islamic banking industry's assets is currently worth more than one-trillion dollars (PWC, 2010). These assets are contributed by both Muslims and non-Muslims. According to the Birmingham Post (3 October, 2008), non-Muslims are normally attracted to Islamic banking products because of the reliability and stability of the products that Islamic banks (IBs) offer. They feel secure as Islamic banking products have to be constructed on the foundations of real physical assets (Birmingham Post, 3 October, 2008). While for Muslims, they must obey the commands of Allah (swt) that encompass all aspects of life including financial and business; and only Shariah-compliant banking and financing products are in accordance with the commands of Allah. In other words, Shariah-compliance is highly personal to Muslims and not a trivial matter. Therefore, IB managers, along with their Shariah Supervisory Boards (SSB) and auditors, are accountable to users to confirm that the IB operations are aligned with the Shariah. Acceptance of Islamic products, particularly by Muslims, is significantly influenced by the conformity and level of assurance in IBs' reporting.

IBs normally produce two assurance reports separately. The first report addresses opinions on the financial statements and the second on Shariah-compliance. These reports are namely auditor's report and SSB report, respectively. Both are two vital mechanisms for disclosure and transparency attestation to stakeholders in assuring the Shariah compliance and Islamic operations of the IBs. Therefore, there is

a need to determine whether these reports are adequately informative and meet the information requirements of the users.

Instead of researching both reports superficially, the study narrows down to one of the reports to be more focused and conducts a more detailed study. The report focused on in this study is the auditor's report, as it is more directly related to the assurance of financial statements, including Shariah compliance.

The current dilemma with regards to IBs' audit report is whether the information is adequate, particularly regarding Shariah compliance. This is important because, as mentioned before, IBs' reporting should provide information that is congruent with Islamic values or the Shariah. Since compliance with the Shariah is crucial, Islamic banking transactions, in particular, are different from their conventional counterpart. Due to the difference in banking transactions, in accounting these business transactions, IBs have to apply certain alternative "Islamic" principles. However, the Malaysian Accounting Standard Board (MASB) is adopting the International Financial Reporting Standards (IFRS). There is a plan to bring Malaysia's Financial Reporting Standards (FRS) to full convergence with IFRS by 1 January 2012, as the Board has concluded that there is no necessity for Islamic accounting standards (The Malaysian Reserve, 2009). This is because MASB does not agree that all Shariah-compliant transactions inherently require alternative accounting principles from their conventional methods (MASB, 2009). Although the debate should persist in terms of financial reporting and its standards, particularly in terms of its relevance to Islamic institutions and Shariah-approved companies, such discussions on auditing of these entities as well as their audit reports are lacking. Needless to say, auditors have to issue an opinion whether the financial statements provide a true and fair view and are in accordance with accounting regulations. In addition to assuring

that the financial statements of IBs are in accordance with the financial reporting framework, assurance on Shariah compliance, particularly on IBs' financial statements, are also important. However, whether the IBs' auditor's report makes ample reference to the above is questionable.

Therefore, the study attempts to investigate the validity of such limitations through the assessment of users' perceptions, as well as to scrutinize the possible inclusions that would make the auditor's report, particularly of IBs, more meaningful to users. Since audit reports are addressed to specific users, accounting bodies like the American Institute of Certified Public Accountants (AICPA) have raised a call in mainstream accounting research to study perceptions of users on these reports (AICPA, 2006). Regretfully, the lack of research to understand the perceptions of users on audit reports is also not evident in the perspective of Muslims as Shariah-compliant users, specifically for IBs.

Users may come from diverse backgrounds, carry different roles and have different aims in using the auditor's report (Muhammadun, 2006). Even though there are various groups of users utilising the audit reports, this study focused on the perceptions of depositors, particularly accounting students, on the content of the auditor's report. It is found that students are the most appropriate subjects as the study applies an experimental approach for the research method, as used by many prior studies (Libby, 1979; Hatherly et. al, 1988; Innes et. al, 1997 and Leung and Chau, 2001). Discussions on samples and experiments will be provided in the research methods chapter.

For over a decade, the conventional auditor's report has continuously been improvised and improved so that its content would be more useful and relevant to users. Similarly, Muslim users' needs and perceptions should also be relevant and



properly addressed by the auditor's report, particularly on IBs. As such, the study has proactively attempted to provide a proposal of an expanded auditor's report, taking cues from the Shariah auditing literature. If through this study, it is perceived that the current audit reports of IBs are inadequate, then this study's proposal of an expanded auditor's report may be considered as more relevant to users of IBs' auditor reports than existing audit reports. This is because, as mentioned before, the current auditor's report of IBs could possibly lack vital information, particularly regarding Shariah compliance.

The study firstly determines whether users feel there is actually a difference between the existing and expanded auditor's reports especially in the circumstances of IBs. Secondly, it questions which information in the expanded auditor's report would be deemed as meaningful and perceived favourably by the users compared with the current auditor's report. Finally, the study determined via analysis whether there is an association between users' level of Islamic education and their perceptions on the content of the auditor's report. These objectives of the research are clearly specified in the next section.

## **1.2 OBJECTIVES OF THE STUDY**

This study attempts to enhance our general understanding on the perceptions of the current audit reports of IBs and consequently determines the possible need for an improved auditor's report, hence improving the clarity of its content. The study further evaluates users' perceptions based on the improvements that are suggested in the proposal of expanded auditor's report. Through the perceptions derived from the experiment, the researcher will recommend more clarity in information in IBs' audit reports. In addition, the study investigates whether there are any associations between

users' level of Islamic education and their perceptions of the content of the auditor's report. Therefore, the research objectives of this study are:

1. To determine the difference in perception of users (accounting student depositors) on the existing auditor's report and the expanded auditor's report.
2. To identify the information that should be included in the expanded auditor's report as perceived by users (accounting student depositors).
3. To determine whether an association exists between users' level of Islamic education and their perceptions of the content of the auditor's report.

The research questions formulated to attain the abovementioned objectives are as follows:

1. *Are the contents of the expanded auditor's report and existing auditor's report perceived differently by the users (accounting student depositors)?*

This question is to elicit general perceptions among respondents of the auditor's report.

2. *What is the information that should be included in the expanded auditor's report as perceived by users (accounting student depositors)?*

This question seeks to generate users' perceptions of both auditor's report contents and details. The contents and details of the proposed expanded auditor's report are based on the elements adopted from the literature.

3. *Are there any associations between users' level of Islamic education and their perceptions of the content of the auditor's report?*

This question encompasses the investigation of the association based on the first two research questions on perceptions of both content of auditor's

report and the personal trait of the subjects, particularly in terms of Islamic education background.

To answer the questions, two sample groups from final year undergraduate student depositors in two public universities in Malaysia were selected as respondents for this study. These individuals were selected due to their understanding of auditing and Islamic accounting. Therefore, it was expected that the choice of respondents was relevant hence able to give their views on the particulars sought by the study. After stating the aims of the research and the research questions, the next section presents the motivation of the study.

### **1.3 MOTIVATION OF THE STUDY**

The motivation of the study is to determine if the content of the auditor's report provide additional communication on Shariah-compliant information and to improve transparency by IBs. A clearer communication of Shariah-compliance in the auditor's report is vital to both users and auditors of IBs. Without clear communication of Shariah-compliance in the auditor's report of IBs, it may cause misunderstanding among users particularly Muslims. For auditors, they need to disclose sufficient, useful, relevant and reliable information as required by regulators in order to gain public confidence in general.

This study is also motivated to answer the call by regulators and professional institutes including the International Auditing and Assurance Standard Board (IAASB), International Organization of Securities Commissions (IOSCO) and American Institute of Certified Public Accountant (AICPA) for suggestions to improve the standard auditor's report (AICPA, 2006 and IOSCO 2010). The study

also looks forward to spur more discussions of Shariah-compliant elements in the auditor's report, which currently seems very encouraging.

This study also desires to initiate efforts to develop clearer reports and standardise the reporting of Islamic elements in the auditor's report of IBs. The study seeks to highlight changes that are applicable across IBs worldwide rather than only respond to unique country-specific factors in order to avoid adoption barriers in the banking industry. It is an attempt to promote an auditor's report that is more effective, consistent but still acceptable for any jurisdiction.

Most importantly, the study wishes to fulfill the *fard kifayah* to protect Muslims from possible risks arising from the IBs' failure to comply with Shariah principles. Therefore, it is critical to be precise on the disclosures to the nature of assurance provided by the auditors. By initiating an effort to increase the quality of disclosure and transparency, it would at least reduce the gap in the Shariah-compliant disclosure practices.

Finally, this study will contribute to research in auditing, specifically from an Islamic perspective. There is a scarcity of empirical research in this particular area. Such research on auditor's report is essential for the Islamic banking sector to strengthen and grow. It is believed that the study will be the first empirical study conducted to engage in the issues of adequacy of disclosure, particularly Shariah-compliant disclosures of IBs' audit reports.

#### **1.4 CONTRIBUTION OF THIS STUDY**

This study contributes in five ways to the current research and practice of auditor's reporting. The study's main contribution is by developing a proposal of expanded auditor's report that would cater for Shariah-compliant banking industry. With the

questions raised by practitioners and the public about the value of the current auditor's report, the proposal of an expanded auditor's report is made to promote meaningful and relevant information into the context of IBs. It is the researcher's hope that it would provide information that would assure Muslim users of Shariah aspect of the audit report.

Secondly, the study attempts to substantiate whether the existing practice of auditor's report is sufficient or otherwise, hence requiring improvements if it is the latter. Thus, information in the auditor's report should be assessed first. If users perceived no information loss from the existing auditor's reports, then the resources of research, management and auditor's practice could be diverted to more socially beneficial ends.

On the other hand, if it were found that the IBs' auditor's reports should be improved, this study proposes a more comprehensive and precise, rather than only an extensive, auditor's report. The study by Almer and Brody (2002) evidenced that the auditor's communication with users by nature are ambiguous. Therefore, the third contribution of the study is to provide suggestions on how to determine and communicate the level of assurance in the auditor's report more accurately.

Fourthly, it is hoped that the findings of this study will facilitate IBs in marketing their services and products. By knowing that the background of formal education influences depositors' perceptions, IBs could further profile the depositors' education background and fulfill their assurance needs accordingly in order to capture a bigger market. However, if it is found that perceptions of Shariah assurance are not based on the background of formal Islamic education, perhaps this is due to reflections of the general public. This will also provide opportunities for further research.

Finally the study contributes to the body of knowledge in the subject matter of this research. Theoretically, the study enriches the literature on the extent of auditor's reporting by incorporating Islamic reporting and communication theory into the study of auditor's reporting. Moreover, as discussed above, the current auditor's report, which is from a conventional framework may not be ample for Islamic banks, hence studies on auditor's report, specifically geared towards Islamic banks need to be initiated to fill the gap in the literature. This study is merely an initial step in that direction.

In summary, as it is expected that IBs have gained prominence in a relatively short period of time, the study hopes to contribute to knowledge, assist policy makers as well as provide certain practical implications for the betterment of IBs and the *ummah* as a whole. The next section is the final section of this chapter on the organization of the dissertation.

## **1.5 ORGANISATION OF THE DISSERTATION**

This dissertation consists of six chapters, beginning with Chapter 1 which introduces the background of the study where the problem statement is inferred, objectives of the study, motivation of the study and specifies the contributions to be derived from the study.

Chapter 2 discusses the findings of past studies or the literature review on conventional corporate reporting and corporate reporting from an Islamic perspective. The chapter begins with a review of existing research relating to the external auditor's report in general and on the communication of assurance. This is followed by a review of the literature on Shariah auditing and perceptions related to IBs. The chapter concludes with a gap of the literature.

Chapter 3 discusses accounting as a communication process. The communication theory is useful in analysing and enhancing communication associated with the auditor's report. The accountability theory is also discussed, where relevant, in this chapter. The discussion is specifically on how the concept of accountability applies to financial reporting from an Islamic perspective. Both of the theories are further used in developing the study's hypotheses.

Chapter 4 details the research method of the study. The chapter begins with an introduction, followed by discussions on the research design and highlights on the measurement and analysis. The results and analysis of the findings are discussed in Chapter 5. Finally in Chapter 6, the conclusion of the dissertation is provided and the implications of this study are drawn. The limitations of the study and recommendations for future research in this field are given in the chapter.

## **CHAPTER 2**

### **LITERATURE REVIEW**

#### **2.1 INTRODUCTION**

The previous chapter briefs the background of the study and the reasons to focus on auditor's report. This chapter begins with the most recent debate and evolution of the auditor's report to discard the allegation that it is too rigid for changes and illustrate the dynamic nature of auditor's report in actual practice. This is followed by a critical review of the relevant literature to the dissertation. The study reviews research relating to the reporting and to the communication studies in accounting. This is followed by a specific overview of Malaysian IBs and specific financial reporting regulations; prior discussion on the main thrust of arguments is put forward in the literature related to Shariah auditing and perception studies related to IBs. The chapter ends by identifying the gap in the literature, which the study intends to fill.

#### **2.2 CURRENT DEBATE**

The standard auditor's report is the primary means by which auditors communicate to users of financial statements regarding their audit. In order to protect stakeholders of the company, regulators must ensure that business entities have disclosed the required sufficient, useful, relevant and reliable information (IOSCO, 2009). According to the International Standard of Auditing (ISA) 200, a financial statement audit is designed to enhance the degree of confidence of intended users in the financial statements. The degree of confidence is always dependent on assurance given through the audit and its findings are reported. However, based on the roundtable discussions and forums