

How timeliness of audit reports effects financial statements



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Introduction

One of the important issues affects the timeliness of the financial statements which convey financial information to investors is the timeliness of the audit reports (Dopuch et al., 1986; Field and Wilkins 1991; Loudder et al., 1992).

The financial information timely disclosure through audited financial statements plays an important role in reducing the asymmetric dissemination of financial information (Jaggi & Tsui, 1999).

Indeed, the shorter the time between the end of the accounting year and the publication date, the greater the benefits that can be derived from the financial statement. The delay in disseminating the financial statement is most likely to boost uncertainty associated with the decisions made based on the information contained in the financial statements. Thus, the decision may not be of superlative quality (Abdulla, 1996).

It has been found by many empirical and analytical evidences that the timeliness of financial statement has some impacts on the firms' value (Beaver, 1968; Givoly and Palmon, 1982; Chamber and Penman, 1984; and Kross and Schroeder, 1984). Such as, Beaver (1968) asserted that investors may postpone their purchases and sales of securities until the earnings report is released. Givoly and Palmon (1982) contended that the price reaction to the disclosure of early earnings announcements was significantly more pronounced than the reaction to late announcements.

In a like manner, the investors would probably search for an alternative source of information. The delayed dissemination of financial information may encourage certain unscrupulous investors to acquire costly private pre-
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disclosure information and exploit their private information at the expense of 'less informed' investors (Bamber, Bamber, and Schaerbeek, 1993).

Issue on audit report delay should be given attention. This is to correspond with the Saudi government's inspiration to make this country the top one in the Middle East attracting the foreign investment and encouraging the local companies to involve in the free market strategies. For this thing, with the rapid development of the global markets and their demands, there is no excuse for listed Saudi companies to treat such development and changes as non-essential events, especially in financial statements disclosure.

Problem Statement

In view of the fact that timeliness is an important qualitative attribute of financial statements, which requires information to be made available to the users as rapidly as possible. The increase in the reporting delay reduces the information content and the relevancy of the documents. The recognition that the length of audit may be the single most important determinant affecting the timing of earnings announcement (Whittred, 1980; Givoly and Palmon, 1982; and Carlsaw and Kaplan, 1991). In such important issues related to the financial statements' timeliness, this study attempts to investigate the determinants of audit delay for companies listed on Saudi Arabia Stock Exchange (Tadawel), a developing capital market, providing further evidence on the factors of audit delay in Saudi Arabia. This study extends the previous studies by focusing on the Saudi Arabia setting with more recent data.

Research Questions

In general, this study seeks for explanation on how Saudi listed companies' external auditors delay in issuing their audit reports. Specifically, the following research questions would be addressed in this study:

1. What is the audit report delaying status among Saudi listed companies' external auditors?
2. What are the factors that determine the length of time the Saudi listed companies' external auditors require to complete their audit reports?
3. How do the following factors influence the Saudi listed companies' external auditors to delay issuing their audit reports?
 - a) Company size.
 - b) Audit firm technology.
 - c) Subsidiaries.
 - d) Extraordinary items.
 - e) Audit opinion.
 - f) Sign of income.
 - g) Debt proportion.

1. 4 Research Objectives

The general objective of this study is to gain useful insights on audit delay determinants among Saudi listed companies. Specifically, the study tries to achieve the following three objectives:

To identify the audit report delaying status among Saudi listed companies' external auditors.

To identify the factors that determine the length of time the Saudi listed companies' external auditors take to complete their audit reports.

To examine if there is any relationship between company size, audit firm technology, subsidiaries, extraordinary items, audit opinion, sign of income, and debt proportion with the audit report delay.

Significance of the Study

Issue on audit report delay is not conclusive. Although there are several studies have been conducted in different developed and developing countries, there are still a number of countries that have not been tapped to investigate the determinants of the audit report delay. This study is considered the first study conducting the determinants of audit report delay among listed companies in Saudi Stock Exchange. Moreover, this study will be conducted under the Saudi business environment, unlike the other studies that have been conducted under different business environments. But still this study will get benefit from the variables in the previous studies that are relevant to the developing capital markets such as company size, audit firm technology, subsidiaries, extraordinary items, audit opinion, sign

of income, and dept proportion. Thus, this study may extend the existing literature in explaining the audit report delay in Saudi Arabia.

Scope and Limitations of the Study

This study has been conducted with several limitations such as:

The study is conducted only among public listed companies that are operating in Saudi Stock Exchange. These companies are focused due to the availability and accessibility of data to be collected.

Although a sufficient number of companies to be included in the sample size can be obtained, the actual number of companies that would be used in the analysis may be smaller. This is because the size of the sample depends on the questionnaires returned by the respected companies. In other words, not all companies chosen will return or fully complete the questionnaires given.

Used in this study reflects the audit work from the year-end to the audit report date. Audit work conducted outside this period has not been considered in the analysis.

Audit report lag is measured in terms of days rather than man-hours spent on audit work. This could create a measurement problem if audit firms spend more than a normal day's work on the audit.

be other factors, such as administrative approval process with the home office, which affects ARL and have not been included in the model

Incorporating corporate governance characteristics into the analysis (e. g. quality and independence of management and board membership) might shed more light on the structure and dynamics of the audit report lag.

The above- mentioned limitations have narrowed down the scope of the research and hopefully, the output result could be useful.

Organization of the Study

This remainder of the research proposal is divided into four chapters. The next chapter, Chapter 2, provides a review of related literature about audit report delay determinants. Chapter 3 emphasized on the research methodology, which begins with theoretical framework, hypotheses development, model specification, variable measurement and data collection. Chapter 4 presented the empirical findings and results obtained from the questionnaire, validity analysis, reliability analysis and multivariate logistic regression. Finally, chapter provides the discussion and implications of the study as well as suggestions and recommendations for future research.

CHAPTER TWO

LITERATURE REVIEW

Introduction

This Chapter discusses and summarizes the literatures on all variables under study. The first part of this chapter discusses on audit report delay. The literatures are arranged according to dependent variable and independent variables. The dependent variable i. e company size is discussed first. The

rest of the chapter summarizes all the independent variables. There are seven independent variables involve in the study.

Audit Report Delay

The timely publication of companies' financial information depends on the time taken to complete the audit. The audit report delay is a particularly critical factor in emerging and newly developed capital markets where the audited financial statements in the annual report are the only reliable source of information available to investors (Leventis et al, 2005).

Establishing the confidence of investors requires reliable and timely accounting information. In emerging capital markets, the audited financial statements in the annual report are likely to be the only reliable source of information available to the market. There is inevitably a gap between the end of the financial year and the dissemination of the audited financial statements but minimizing that gap would enhance market efficiency. Regulators need to understand the causes of the audit report delay before they can legislate effectively to reduce it.

Audit report lag is a problem that crosses frontiers but previous research has focused largely on developed capital markets (Walker & Johnson, 1996). Subsequently, Timeliness of financial statements is the focus of an increasing amount of attention by accounting researchers and regulatory bodies (Knechel & Payne, 2001). Managers are expected to prefer a minimal audit report delay (Johnson, 1998). Auditors are expected to perform assurance services without lags, within the constraints imposed by professional codes and ethics. The issue of timely reporting has received

attention in US markets with the announcement of phased reductions in reporting time limits from 90 days after the financial year end to 60 days by 2005 (SEC, 2002).

The studies that have been conducted to examine audit lag for companies in the US are (Givoly & Palmon, 1982; Ashton et al., 1987; Bamber et al., 1993; Kinney & McDaniel, 1993; Schwartz & Soo, 1996; Henderson & Kaplan, 2000; Knechel & Payne 2001), Canada (Newton & Ashton, 1989; Ashton et al. , 1989), Australia (Davies & Whittred, 1980), New Zealand (Courtis, 1976; Carslaw & Kaplan, 1991) and France (Soltani, 2002). The only studies that could be regarded as exploring emerging or newly developed capital markets relate to Hong Kong (Ng & Tai, 1994; Jaggi & Tsui, 1999), Zimbabwe (Owusu-Ansah, 2000), Bahrain (Abdulla, 1996) and Pakistan (Hossain & Taylor, 1998). In general these studies use public domain data; exceptions are Ashton et al. (1987) and Knechel and Payne (2001) who were given access to audit firms' data. All the above studies have provided empirical evidence that audit timeliness is the most influential factor in the timeliness of financial statements (Owusu-Ansah, 2000).

Company Size

Most of the previous studies found a negative association between the audit delay and the company size. This is possibly due to strong internal control and the ability to pressure auditors to complete the audit work in a timely manner (Carslaw and Kaplan, 1991; Courtis, 1976; Davies and Whittred; Givoly and Palmon, 1982; Newton and Ashton, 1989; Ashton et al, 1989; Bamber et al, 1993; Schwartz and Soo, 1996; Jaggi and Tsui, 1999; Owusu-Ansah, 2000). Furthermore, larger companies have more resources to pay <https://assignbuster.com/how-timeliness-of-audit-reports-effects-financial-statements/>

relatively higher audit fees and are able to settle the fees soon after the companies' year-end. Thus, it is likely that the audit-reporting lag for larger companies is lesser than those of smaller ones. (Dyer and McHugh, 1975) argued that the management of larger companies has greater incentives to reduce both audit delay and reporting delay since they are closely monitored by investors, trade unions and regulatory agencies. This larger external pressure forces them to report on a timely fashion. Therefore, prior researchers have argued that to reduce the uncertainty about performance that may reduce the share price, the larger firms tend to complete their audit work as soon as possible to release the annual reports (Davies and Whittred, 1980; Ashton et al., 1989; Carslaw and Kaplan, 1991 and Abdulla, 1996).

Audit Firm Technology

There are few literatures found regarding audit firm technology and its relationship with the audit report delay. Newton and Ashton, (1989); Schwartz and Soo, (1996) found that there is a positive relationship between audit firm technology with structured audit approach delay releasing the audit report longer than the unstructured audit approach. The previous study done by Bamber et al. (1993) developed a comprehensive ARL model to examine the impact of different variables on audit delays for a sample of US companies. The model covers three the variable ' audit firm technology' which is reflected by the audit approach, structured or unstructured. It was found that the audit firm technology significantly affects the audit report delay, meaning that the structured audit firms took a longer time to audit than the unstructured ones. Therefore, based on Bamber et al (1993)

evidence Jaggi and Tsui (1999) conducted a study of Hong Kong companies based on a sample of 393 Hong Kong companies for the 1991- 1993 period. The result of their study showed that companies audited by audit firms using the structured audit approach have longer audit delays.

Subsidiaries

There are few literatures found regarding the number of subsidiaries and its relationship with the audit report delay. Jaggi and Tsui (1999) conducted a study of Hong Kong companies based on a sample of 393 Hong Kong companies for the 1991- 1993 period. The result of their study showed that companies have larger number of subsidiaries take longer audit delays than the ones have smaller number of subsidiaries. On the other hand, Ng and Tai (1994) found that there is no relationship between the number of subsidiaries and the audit report delay.

Extraordinary Items

Several prior studies have included extraordinary items as a function of audit delay. (Newton and Ashton, 1989; Carslaw and Kaplan, 1991 and Bamber et al, 1993; Schwartz and Soo, 1996). Carslaw and Kaplan (1991) found that extraordinary items were positively associated with audit delay. This is probably because the auditor may need additional time to identify whether a particular transaction falls within the ambit of extraordinary item or a mere exceptional item since the distinction between them is somehow vague.

2. 7 Audit Opinion

Several previous studies found that Companies not receiving unqualified audit opinions are expected to have a longer audit delay compared to the

ones receiving an unqualified (clean) report. Whittred (1980) found that 'subject to' qualification took additional period to make their annual reports public. Carslaw and Kaplan (1991); Ashton et al. (1987) and Newton and Ashton (1989); Bamber et al. (1993), Soltani (2002) also included audit opinion as a function of audit delay investigation. Whereas, Jaggi and Tsui (1999) conducted a study of Hong Kong companies based on a sample of 393 Hong Kong companies for the 1991- 1993 period. The result of their study do not support the findings of earlier studies that qualified audit opinions and companies reporting losses will have longer audit delays.

Sign of Income

There are few literatures found regarding sign of income and the audit report delay. Ashton et al., (1987) stated that the sign is an indication of good or bad news resulting from a year's activity. Carslaw and Kaplan (1991) claimed that a company facing a loss would require the auditor to schedule their audit in order to start the audit later than usual. By doing so, there would be a delay in conveying the bad news to the public. Conversely, companies having higher profitability may require the audit to be completed as quickly as possible in order to quickly release the good news. They also argued that auditors are more cautious during the audit process in response to a company loss if the auditor believes that the company's loss increases the likelihood of financial failure or management fraud.

2. 9 Debt proportion

The previous study done by Carslaw and Kaplan (1991) resulted that Debt proportion as a function of audit delay was the first study introduced. They have argued that the relative proportion of debt to total assets may be <https://assignbuster.com/how-timeliness-of-audit-reports-effects-financial-statements/>

indicative of the financial health of the company. A high proportion of debt to total assets will increase a company's likelihood of failure and may raise in the auditor's mind additional concerns that the financial statements may be less reliable than normal. This is because a high proportion of debt is normally associated with high risk. It may result from poor financial health that could lead to mismanagement and the possibility of fraud. Furthermore, a high proportion of debt may lead to liquidity or going concern problem which requires more tentative audit. In this study, the total liabilities refer to the sum of current liabilities and long-term liabilities

CHAPTER THREE

RESEARCH DESIGN AND METHODOLOGY

Introduction

The first section of this chapter discusses the theoretical framework followed by hypotheses development, model specification, variable measurement, data collection and results of the

Theoretical Framework

The time spent to prepare the audit is the factor determining the timely published financial information. The audit report delay is a particularly important factor in emerging and newly developed capital markets where the audited financial statements in the annual report are the only reliable source of information available to investors (Leventis et al, 2005).

The level of reliable and timely accounting information available is the same level of confidence the investors build. In other words, as much as the investors establish confidence is as much as reliable and timely accounting

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information available. In emerging capital markets, the audited financial statements in the annual report are likely to be the only reliable source of information available to the market. There is inevitably a gap between the end of the financial year and the dissemination of the audited financial statements but minimizing that gap would enhance market efficiency.

Regulators need to understand the causes of the audit report delay before they can legislate effectively to reduce it.

Audit report delay has become a global problem; all the developed and developing capital markets are suffering, but previous research has focused largely on developed capital markets (Walker & Johnson, 1996). Several studies have provided empirical evidence that audit timeliness is the most influential factor in the timeliness of financial statements (Owusu-Ansah, 2000). All the same, Timeliness of financial statements is the focus of an increasing amount of attention by accounting researchers and regulatory bodies (Knechel & Payne, 2001). Managers are expected to prefer a minimal audit report delay (Johnson, 1998). Auditors are expected to perform assurance services without lags, within the constraints imposed by professional codes and ethics. The issue of timely reporting has received attention in US markets with the announcement of phased reductions in reporting time limits from 90 days after the financial year end to 60 days by 2005 (SEC, 2002).

This research tries to investigate the effects of seven variables on factors that influence the timeliness of audit report. Those variables are company size, audit firm technology, subsidiaries, extraordinary items, audit opinion,

sign of income, and dept proportion. Whereas, the dependent variable is audit report delay. Figure 3. 1 below shows the theoretical framework model.

Hypotheses Development

Dependent Variable

Audit report delay is the dependent variable. For the reason that the audited financial statements are the only reliable source of information available to build confidence for the financial statements' users, the audit report delay has become a critical factor in the developed and developing capital markets (Leventis et al, 2005).

Currently, all the empirical and analytical studies have yet provided evidence that audit report delay is the most substantial influential factor in the financial statements timeliness (Owusu-Ansah, 2000). In the same line, the increasing demands of reliable information in the capital markets has led to an increasing amount of attention by accounting researchers and regulatory bodies of the timeliness of financial statements (Knechel & Payne, 2001). With the realizing of audit report delay by the companies and the capital markets, companies will be able to generate timely and reliable financial information.

3. 3. 2 Independent Variable

3. 3. 2. 1 Company Size

Total assets are very important to either big or small companies. The total asset of the company is used to measure the company size. In this study, the total asset refers to the sum of current assets, fixed assets as well as investment and advances. Intangible assets are also included. The total

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assets have commonly been used in previous studies of audit delay to measure size (Ashton et al., 1989; Courtis, 1976; Davies and Whittred, 1980; Gilling, 1977; Newton and Ashton, 1989; Carslaw and Kaplan, 1991; and Abdulla, 1996). (Dyer and McHugh, 1975) found an association relationship between company size and the audit report delay that the management of larger companies has greater incentives to reduce both audit delay and reporting delay since they are closely monitored by investors, trade unions and regulatory agencies. This larger external pressure forces them to report on a timely fashion. Therefore, prior researchers have argued that to reduce the uncertainty about performance that may reduce the share price, the larger firms tend to complete their audit work as soon as possible to release the annual reports (Davies and Whittred, 1980; Ashton et al., 1989; Carslaw and Kaplan, 1991 and Abdulla, 1996). Thus, the first hypothesis is developed as below:

H1: There is a positive relationship between firm's size and audit report delay.

3. 3. 2. 2 Audit Firm Technology

Audit firm technology refers to the structured and unstructured audit approach. . Newton and Ashton, (1989); Schwartz and Soo, (1996) found that there is a positive relationship between audit firm technology with structured audit approach delay releasing the audit report longer than the unstructured audit approach. The previous study done by Bamber et al. (1993) developed a comprehensive ARL model to examine the impact of different variables on audit delays for a sample of US companies. The model covers three the variable ' audit firm technology' which is reflected by the audit approach,

structured or unstructured. It was found that the audit firm technology significantly affects the audit report delay, meaning that the structured audit firms took a longer time to audit than the unstructured ones. Therefore, based on Bamber et al (1993) evidence Jaggi and Tsui (1999) conducted a study of Hong Kong companies based on a sample of 393 Hong Kong companies for the 1991- 1993 period. The result of their study showed that companies audited by audit firms using the structured audit approach have longer audit delays. Because the audit firm technology influences on the audit report delay, the following hypothesis is established:

H2: There is a positive relationship between structured audit approach and audit report delay.

3. 3. 2. 3 Subsidiaries

In this study subsidiary refers to the number of subsidiaries the company owns. Jaggi and Tsui (1999) conducted a study of Hong Kong companies based on a sample of 393 Hong Kong companies for the 1991- 1993 period. The result of their study showed that companies have larger number of subsidiaries take longer audit delays than the ones have smaller number of subsidiaries. Thus, such result has motivated the following hypothesis:

H3: There is a positive relationship between number of subsidiaries and audit report delay.

3. 3. 2. 4 Extraordinary Items

The classification of items will depend on the particular circumstances - what is extraordinary item for one company does not necessarily be extraordinary for another company due to the differences in their ordinary activities.

Subject to this, it poses significant uncertainty that may lead to extended
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negotiation between the auditor and the company. However in Saudi Arabia, the SFAS defined the extraordinary items into gains or losses from natural disaster and expropriation of assets only. This study expects a different finding compared to previous studies as a result of the new definition of extraordinary items. (Newton and Ashton, 1989; Carslaw and Kaplan, 1991 and Bamber et al, 1993; Schwartz and Soo, 1996). Carslaw and Kaplan (1991) found that extraordinary items were positively associated with the audit delay. Thus, the following hypothesis is addressed:

H4: There is a positive relationship between presence of extraordinary items and audit report delay.

Audit Opinion

In this study, audit opinion refers to the qualified opinion viewed as bad news and thus slows down the audit process. Several previous studies found that Companies not receiving unqualified audit opinions are expected to have a longer audit delay compared to the ones receiving an unqualified (clean) report. Whittred (1980) found that ' subject to' qualification took additional period to make their annual reports public. Carslaw and Kaplan (1991); Ashton et al. (1987) and Newton and Ashton (1989); Bamber et al. (1993), Soltani (2002) also included audit opinion as a function of audit delay investigation. Hence, the following hypothesis is reasonably established:

H5: There is a positive association between audit of opinion and audit report delay.

Sign of Income

The sign of income in this study refers to the loss or profit reported by the companies. The companies reporting losses for the period are expected to <https://assignbuster.com/how-timeliness-of-audit-reports-effects-financial-statements/>

have a longer audit delay compared to the ones reporting a profit. Ashton et al., (1987) stated that the sign is an indication of good or bad news resulting from a year's activity. Carslaw and Kaplan (1991) claimed that a company facing a loss would require the auditor to schedule their audit in order to start the audit later than usual. By doing so, there would be a delay in conveying the bad news to the public. Conversely, companies having higher profitability may require the audit to be completed as quickly as possible in order to quickly release the good news. As such, the following hypothesis is developed:

H6: There is a positive association between sign of income and audit report delay.

Debt proportion

In this study, the debt proportion refers to the equation computed by dividing the total liabilities by the total asset. The total liabilities refer to the sum of current liabilities and long-term liabilities. The first study introduced was the study done by Carslaw and Kaplan (1991) concluded that Debt proportion as a function of audit. In other words, they have suggested that the relative proportion of debt to total assets may be indicative of the financial health of the company. A high proportion of debt to total assets will increase a company's likelihood of failure and may raise in the auditor's mind additional concerns that the financial statements may be less reliable than normal. This is because a high proportion of debt is normally associated with high risk. It may result from poor financial health that could lead to mismanagement and the possibility of fraud. Furthermore, a high proportion

of debt may lead to liquidity or going concern problem which requires more tentative audit. Therefore, the following hypothesis is developed:

H7: There is a positive association between debt proportion and audit report delay.

Data Collection

Population

In this study, the population frame will include all the public listed companies in Saudi Stock Exchange (Tadawel). According to Tadawel, there were 108 companies listed in both main board and second board of Saudi Stock Exchange as at 10 November 2007. Therefore, the population frame of this study will be based on all the listed 108 companies.

Sample Selection

A sample was selected of all the listed companies in the Saudi Stock Exchange which were 108 companies due to the small sample size. However, in order to balance the number of companies in different groups of industry, all the listed companies have been taken into deeply consideration. Thus, all the companies have been categorized into groups as same as the category of Tadawel as follows: financial sectors (25 companies), industrial sectors (46 companies), service sectors (28 companies), and agricultural sectors (9 companies).

Procedures

In this study, data will be collected in two ways. The first type of data is from the primary source. The internet could serve as a primary data source when questionnaires are administered over. The questionnaires will be distributed

to the companies that have been chosen as a subject. A set of questionnaire will be e-mailed to each company.

Second way is through secondary data, where the data will be taken from the existing sources such as the websites of the companies, annual reports, articles, annual reports, magazines, internet, newspaper, government publications, journals, company records or archives, doctoral dissertations as well as master's thesis. While seeking for secondary data, it will save time and costs of acquiring information. These sources of secondary data provide a lot of information for research and problem solving (Sekaran, 2003). Using the internet Netscape Navigator to carry out the study, a survey of the companies' websites or home pages was conducted in order to know the companies total assets and their profitability.

Also, the researcher has letters sent out to those companies where the websites could not be found directly through the internet. The letters were designed to find out whether the companies have websites on the internet and their websites addresses.

Measurement of Variables

Dependent Variable

3. 5. 1. 1 Audit Report Delay (ARD)

For the purpose of this study, the number of days between the date of the financial statement and the date of the auditors' report was used to measure the audit delay.

3. 5. 2 Hypotheses Variables

3. 5. 2. 1 Company Size (SIZE)

Total assets are the total value of resources owned by businesses. The size of a company can be measured in a number of ways, such as capital employed, turnover, number of employees and company's market value.

There is no overriding theoretical reason to select on rather than another. In this study, the total asset of the company is used to measure the company size. Therefore, the total assets of each company will be gathered from the latest published annual reports. The amount of fixed assets added with current assets will equal to the amount of company's total assets.

Audit Firm Technology (AUDTEC)

Audit firm technology refers to the structured and unstructured audit approach. Auditors are classified into the Big Five and the non - Big Five. The Big Five refers to Arthur Andersen, KPMG Peat Marwick, Ernst & Young, Pricewaterhouse Coopers an