AUDIT COMMITTEE ACTIVITY AND AUDIT REPORT LAG IN SAUDIA ARABIA

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Abstract

This paper examines whether audit committee activity is associated with audit report lag We posit that an effective audit committee reduces Qtcrnal audit efforts, thus reducing audit report lag. Data was obtained from 573 listed companies in Saudi Stock Exchange (Tadawul) for the years 2007-2011. A pooled OLS regression analysis shows that, an active audit committee (more independent members with frequent meetings) is associated with shorter audit report lag. The outcomes of this study have significant implications to the auditor independent issues in the setting of Saudi Arabia.
Keywords', audit committee activity; audit report lag; Saudi Arabia.

Introduction

Audit report lag (described in some studies as audit delay) refers to the time period from a company's financial year end to the date of the auditor's report (Imam, Ahmed and Khan, 2001). It represents one of the most crucial factors that influence the timeliness of earning announcements (Givoly and Palmon, 1982; Ashton. Willingham and Elliott, 1987). Majority of the companies (over 70 %) do not declare their earnings until the issuance of auditor's report (Bamber. Bambcr and Schodcrbok, 1993). Therefore, Audit Report Lag (hereafter ARL) provides a key role in the transference of audit information to the market (Dopuch, Hollhausen and Leftwich, 1986; LaL Chcuk and Horn, 2005) and has been associated with the market reactions (Chambers and Penman, 1984). Likewise, researchers (e g., Newton and Ashton, 1989; Afify, 2009) indicated that ARL is considered as one of the critical indicators of audit efficiency and thus, efficient auditors should perform more timely audits. Moreover, researchers and professional agencies consider the timeliness of financial reporting (ARL is the most influential factor in timeliness) as an important characteristic which reflects the relevancy and reliability of financial information and financial information becomes less relevant with the passage of time (FASB, 1980; Hcndrikscn and Van Brccda, 1992; Lawrence and Glover. 1998; McGee and Tarangclo. 2008),

Along the same line, researchers (e.g. Prickctt, 2002; Kulzick, 2004) argued that the timeliness of financial reporting reflects one of the important aspects of transparency of financial information and therefore, represents one of characteristics of good corporate governance identified by international organizations such as OCED and World Bank (McGee and Yuan, 2008). Furthermore, Khasharmch and Aljifri (QlO) argued that ARL has greater importance especially for emerging economies since other non-financial statements such as news conferences, media releases and financial analysts' forecasts are not well developed In addition, the regulatory bodies in these markets arc not as effective as in western developed countries (Wallace and Briston, 1993: Chahine and Tohmc, 2009).

Due to the importance of ARL, several previous studies have examined this issue in different settings and these studies arc still suffering of inconclusive and limited results (Leventis et a!.. 2005; Chc-Ahmcd and Abidin, 2C0L El-Bannany, 2008: Lee et al., 2008; Afify, 2009; Khasharmch and Aljifri, 2010; Mohamad-Nor et a!., 2010; Hashim and Abdul Rahman, 2011; Mohamad-Nor et al., 2010; El-Bannany. 2008), One of the issues ignored by the extant research in the discipline of ARL is corporate governance mechanisms (especially audit committee activity) that have a direct responsibility to monitor financial reporting process and to improve the quality of financial reporting. Timeliness of financial reporting is considered as one of the critical characteristics that reflect the relevancy and reliability of financiaQiformalion (McGee and Tarangelo, 2008).Therefore, researchers (Abdulla, 2007; Afify. 2009: Mohamad-Nor et al., 2010; Hashim and Abdul Rahman, 2011) have begun to examine the relationship between corporate governance mechanisms (board of directors and audit committee) and the timeliness of financial reporting due to direct responsibilities of these mechanisms in financial reporting process. This is due to the importance of ARL especially for the emerging markets such as Saudi Arabia, since the information in these markets is limited and these markets have a longer time lag (Errunza and Losq. 1985; Khasharmch and Aljifri. 2010). Therefore, the current study examines the association between audit committee effectiveness (an interaction between aud0committee independent members and audit committee meetings) and ARL among Saudi listed firms.

The objective of this study is to examine whether the audit committee activity could assist in reducing ARL. Such examination is important since none of previous studies examined this relationship in the Saudi context. Hence, this study aims to answer the following research question: "Could audit committee activity reduce company's ARL'T

Saudi Arabia is used as a setting to address the research objectivities due to several reasons. Firstly, it is surprising that none of the previous studies linked between audit committee activity as an interaction between audit committee independent mcmcbcrs and meeting with audit report lag in Saudi jbia. Further, ARL has a greater importance especially for emerging economics since other non-fmancial statements such as news conferences, media releases and financial analysts' forecasts arc not well developed. In addition, the regulatory bodies in these markets are not as effective as in western developed countries (Wallace and Briston, 1993; Chahine and Tohme,2009).

Therefore, these markets have a longer time lag (Khasharmeh and Aljifri, 2010)

This study contributes to the audit literature by examining association of audit committee activity and ARL. The findings of the study would have implication for many parties in Saudi Arabia. It provides supporting evidence for the external auditors in Saudi Arabia on whether audit committee activity could significantly decrease ARL. Furthermore, this study could assist managements of companies in Saudi Arabia to focus on the important role of audit committee and reducing timeliness of financial reporting. Finally, this study could assist regulators in Saudi Arabia to focus on the important role of AC in reducing timeliness of financial reporting.

The rest of this paper is structured as follow. The next section reviews the literature on audit committee activity and ARL. and develops the testable the study's hypothesis. This is followed by the design of the research. It further provides the results of the analysis and discussion. The final section concludes and discuses limitations and suggestion for future research.

Literature Review anti the *study*\ hypothesis Development

Audit Committee Activity and Audit Report Lag

Audit committee plays an important role in relation to monitoring fmancia@:cporting (POB 1993). Smith Report states that one of the responsibilities of AC is to "review the significant financial reporting issues and judgments made in connection with the preparation of the company's financial statement" (Smith Report. 2003, p.10), in USA, the Sarbanes Oxley Act (SOX 2002) determines the function of AC as: (1) to supervise the process of financial reporting of the firm. (2) to oversee the financial statement audit of the firm, (3) to ensure the effective internal control system of the finn. and (4) to oversee external auditor's work. Thus, audit committee is seen as a vital part of the overall corporate governance of the firm and the ultimate monitor of financial reporting (BRC 1999; Klein.

2002).

More importantly, Bedard and Gcndron (2010) conclude that AC can enhance information quality directly by overseeing the financial reporting process and indirectly, through their supervision of internal control and external auditing. Moreover, it is argued that the issue of timeliness of financial reporting is important because it is associated with corporate transparency (Abdulla. 2007). However, there are few studies linked between the characteristics of AC and ARL.

Rcinstcin *et al* (1984) mentioned that outsi(@ audit committee members could have the ability to be able to display and fulfill their fiduciary duties by upholding their dependence upon the audit committee pertaining to affairs such as the capability of the firm s financial reporting, internal control structure and relationship with its externa! auditor.

Similarly, Q: agency theory indicated that improving the independent director's monitoring is expected to result in incentives for such directors to build and maintain reputation as decision control experts (Fama and Jensen, 1983), Accordingly, the independence of audit committee members is considered as an essential determinant of audit committee effectiveness (BRC, 1999: DcZoorU Hcrmansoih Archambeault & Read. 2002: Koh *et al*.. 2007: Pomeroy and Thornton, 2008).

Abdul!a (2007) is one of the first researchers who examined the effect of the independency of audit committee on ARL for the non-financial companies listed in the main board of Bursa Malaysia for the financial year of 1998 and 2000. The results reported insignificant effect of audit committee independence on ARL Furthermore, Afify (2009) reported a significant negative association between the existences of audit committee on ARL for the Egyptian listed companies for year 2007 Likewise, Mohamad-Nor *el al* (2010) investigated the impact of audit AC’s characteristics on ARL in Malaysia for the non-financial companies on the main and second boards of Bursa Malaysia in 2002 However, they found that the independence of audit committee had insignificant association with ARL. More recently, Hashim and Abdul Rahman (2011) linked bct0:cn the characteristics of audit committees and ARL among 288 listed companies at Bursa Malaysia for a three year period from 2007 to 2009. The findings showed that audit committee independence had a negative association with ARL in Malaysia

With respect to audit committee meetings, it frequently represents one of the characteristics that reflect effectiveness as BRC (1999) suggests that audit committees that meet frequently arc more likely to be active in achieving their duties and to be well-informed of auditing issues. Likewise, Mcnon and Williams (1994) consider audit committee's meeting frequently as a signal of AC diligence. Hashim and Abdul Rahman (2011) suggested that audit committee meetings arc one of the important indicators in ensuring audit committee members arc fulfilling their responsibilities toward the company. Indeed. Mohamad-Nor *et at.* (2010) found that audit committee meetings had a negative association with ARL in Malaysia.

Unlike the previous studies, the current study investigates the audit committee characteristics, namely; independence and meetings, as an interaction referred to as "audit committee activity.” The reasoning behind using such a measure is that the ideal combination of corporate governance mechanisms is considered invaluable in decreasing the agency cost and safeguarding the shareholders* interests owing to the effectiveness of corporate governance achieved through various channels and specific mechanism s effectiveness hinges on the effectiveness of other factors (Cai et al., 2009), Additionally, Ward et al. (2009) claim that it is more optimal to examine the corporate mechanisms as a group of mechanisms protecting shareholders' interests and not as individual entities because they complement each other or are alternates for each other. They added that the previous studies provided inconsistent findings because they examined them individually and how each may contribute in resolving agency problems in isolation: in other words, they overlooked that individual mechanism* s hinges on its counterparts. Similarly, Agrawal and Knocbcr (1996) stated that the findings of the individual mechanism's impact may be erroneous as the impact of some single mechanisms is diminished in the combined model. Along the same line, the measurement of the interaction impact indicates a stronger effect as compared to measurement of individual impacts (O* Sullivan et al., 2008).Therefore, the hvpolhesis developed by this sludv is stated in the follow ing direct form

H: There is negative relationship between audit committee activity and the audit report Jag.

Research Design and Model Specification

The populatQi of interest comprises a!! companies listed on Saudi Stock Exchange (Tadawul) (banks & financial services, petrochemical industries, cement, retail, energy & utilities, agriculture and food industries, IT and telecommunications, insurance, multi investment, building & construction, real estate development, transportation, and media & tourism) for the years 2007-2011. This selection is the most recent test period fQ which data were available at the time this study is carried out. Further, the boom of Saudi Arabia clearly emerged in early 2005 (Chahine & Tohmc, 2009). A cross-sectional review of audit reports of thcgample companies listed on Saudi Stock Exchange was undertaken. Samples selected depicted in Table 1

Table 1:
Sample Selection *n* 2013

	Total Observations
Total observations	**622**
Observations discarded (outliers, missing and incomplete data)	**(49)**
Final sample	**573**

The audit report lag model used in this study is adapted from prior studies to accommodate the audit committee activity in the Saudi environment. We include several control variables which have been found to be associated with audit report lag. These variables arc firm size *(SIZE)*, firm performance *(ROA).* and leverage *(LEV).*

The control variables are based on prior researchers regarding audit report lag. Researchers (e,g., Henderson and Kaplan. 2000: Ahmed0id Kamarudin, 2003: Chc- Ahmcd and Abidin, 2008: El-Bannany, 2008: Lee et al, 2008: Afify, 2009: Mohamad-Nor et aL 2010; Hashim and Abdul Rahman, 2011) found a negative association between firm size and audit report lag. With regard to the association of finn performance and audit report lag, several empirical studies (Dyer and McHugh, 1975: Carslaw and Kaplan. 1991; Bambcr et al., 1993; Almosa and Alabbas, 2007) reported a positive association. Finally, It is a matter of dispute whether the relative proportion of debt to total assets could be indicative of financial health of the company (Carslaw and Kaplan, 1991) and a prominent proportion of debt could result in liquidity or going-concern problems which necessitate more tentative audit (Ahmed and Kamarudin. 2003). Moreover, Chc-Ahmcd and Abidin (2008) indicated that the amount of long-term debt may also raise the agency cost as suggested by Jensen and Meckling (1976) which leads to the increase of audit efforts and hence, increase in the length of audit engagement. Furthermore, studies (Carslaw and Kaplan. 1991: Ahmed and Kamarudin, 2003: Abdullah. 2007: Lee et al. 2008) showed that firms with a high proportion of debt have longer ARL Hence, this study adopts the positive effect of debt ratio on audit report lag.

The following is the hypothesize Audit Report Lag (ARL) model:

ARL = $p0$ +pi AC_ACTIVITY + $p2$ SIZE + $p3$ ROA + $p4$ LEV + e

Where:

ARL	Audit Report Lag: a number of calendar days from fiscal year- end to the dale of the auditor's report
Test Variable	
AC_ACTIVITY	An interaction of the percentage of independent non-executive members on the audit committee and audit

	committee meetings during the year
Control Variables	
SIZE	Firm size, natural Logarithm of total assets of the company
ROA	Return on assets, net income divided by book value of total assets
LEV	Leverage, total liabilities to total assets. Total liabilities refer to the sum of current liabilities and long- term liabilities.

Results

Descriptive Statistics and Correlation Analysis

Table 2 reports the descriptive statistics of all variables investigated in this study. The mean of the number of calendar days from fiscal-year eQ to date of externa! auditor's report (*ARL*) is 34.39 days (standard deviation of 13.38 days) with actual minimum of 8 days and maximum of 52 days. This means that the Saudi listed companies take approximately 34 days on average beyond their annual reports date before they arc finally ready for the presentation of the audited financial reports to the shareholders This evidence suggests that the *ARL* may be an important concern for Saudi listed companies in financial reporting policy when compared with other Arab countries. It is important to mention that the average audit report lag of Egyptian companies is 67 days as reported by Afify (2009) and similar to audit lag in Bahrain (51 days) but longer than average of audit lag in United Arab Emirates (43 days) as reported by Khasharmeh and Aljifri (2010).

Table 2:

Descriptive Statistics

Variable	Minimum	Maximum	Mean	Std Deviation
ARL	8	52	34,39	13,38
AC ACTIVITY	0.00	9,00	1,71	1,86
SIZE	65319	332783648	18221180 02	46168347.746
ROA	-21.89	29.80	5.35	7.48
LEV	0.00	69.17	16,08	18.16

Wilh regard lo audit committee activity *(AC_ACTIVITY)*, Table 2 displayed that the mean of the audit committee activity is npproxiQiteh 1.71 wilh a standard deviation of 1.86. As for the firm size *(SIZE')*, The mean is S.R 18221180.02 with a maximum of S R 332783648, a minimum of S R 65319 and a standard **deviation** of 46168347,746, The **firm** performance *(ROA)* ranges **from** 29.80 to -21.89 with an **aA0age** of 5.35 and a standard **deviation** of 7.48. With respect to firm **leverage** *(LEV).* it ranges **from** 69.17 **to** 0.00 with an average of 16.08 and a standard deviation of 18.16

With respect to multicollinearity assumption. Table 3 shows the Pearson Correlation among the independent variables in this study. The highest correlation is between the two control variables, firm size and leverage at 403, which suggests that multicollinearity is not a problem for the regression results,

Table 3:
Pc arson Correlation Matrix

	ACACTIVITY	SIZE	ROA	LEV
AC ACTIVITY	1			
SIZE	**. 158****	**1**		
ROA	**- ,063**	**.069**	1	
I0V	**- ,068**	**.403****	**.077**	**1**

•correlation is significant al the 0.05 level ** Correlation is significant ai tlic 0.01 level

4,2 Multivariate Analysis

Table 4 shows the multiple regression results

Table 4:
OLS Regression Results: The Impact of AC ACTIVITY on ART

Variable	Expected Sign	*fi*	Std. Error	T-Value	p-value	Tolerance	VIF
Constant		,788	.138	5,700	0,000		
			Test Variable				
AC ACTIVITY	-	-,513	,109	-4,697	0,000	0,985	1,015
			Control Variables				
SIZE	+	.061	.022	2.852	0.005	0.831	L203
ROA	+	,027	,002	11,968	0,000	0,987	1.013
LEV	+	,000	,001	-,369	0,712	0,829	1,207
DV ARI, R^2 *.234*	Adjusted R^3 .229	F-Ratio	43.443 Sig F	-.000			

As seen from Table 4, the model explains 22.9 % of the variation in ARL. In general, the mode! is significant *(F* = 43.443) (Sig *F* = 0.000). As for the association between audit committee activity *AC ACTIVITY* and *ARL,* the direction of this relationship is negative and significant at ! % *(fi* = -.513, *t* = -4.697, *P* = .000). This result indicates to the strength of the relationship between *AC ACTIVITY* and *ARL* that means more audit committee activity contributes to the reduction of ARL. This rcsu0is consistent with agency theory prediction and the empirical evidence provided by Mohamad-Nor *et al* (2010) and Hashim and Abdul Rahman (2011) Thus, we accept the study’s hypothesis.

Conclusion

The result of this study shows that audit committee activity contributes to the reduction of audit report lag among listed companies in Saudi Arabia. Such result provides evidence about the importance of audit committee activity in reducing audit lag among listed companies in Saudi Arabia. Thus, listed companies in Saudi Arabia have to emphasize on tissue by increasing the contribution level via enhancing the audit committee activity. Limitations of the study he on the other internal corporate governance mechanisms (i.c.5 board of directors characteristics, audit committee characteristics and ownership structure). Future line of research should put an effort to introduce these mechanisms. Further research should replicate this mode! to determine its validity in different contexts of GCC countries, in different time periods, and with different sample size. These limitations may motivate more future research the GCC market One important implication of these findings relates to the issue of audit report lag in Saudi Arabia, Saudi government stock market, companies and accounting and auditing regulators would gain some new insights from this study in terms of understanding the determinants influencing audit report lag. The results of this study would benefit banks in the way that they can assess the creditworthiness of incorporating companies in Kingdom of Saudi Arabia. The numbers incurred in the audited financial statements are based on to mandate bond covenants. Moreover, credit decisions made by lenders arc determined based on audited financial statements. Therefore, audit report lag issues arc of the utmost important for any lending institution. Investors and financial analysts depend on audited financial statements to make decisions related to bonds, bond rating, interest rate, and all other decisions related to investments in Kingdom of Saudi Arabia market. Accordingly, increased understanding and prediction of companies' events is important to this user group Further, the results of this study will be of interest to the researchers and academic community due to a lack of formal research body addressing the issues of audit report lag in Kingdom of Saudi Arabia and, therefore, this study will provide w ith substantial information about issues in the markets of Saudi Arabia to count on, in the future, as premise data.

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